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Insider Trading Regulation: An Examination of Section 16(b) and a Proposal for Japan

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Insider Trading Regulation: An Examination of Section 16(b) and a Proposal for Japan

Cover Page Footnote

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INSIDER TRADING REGULATION: AN EXAMINATION OF SECTION 16(b) AND A PROPOSAL FOR JAPAN

KANJI ISHIZUMI*

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INTRODUCTION

THE purpose of this Article is to examine section 16(b) of the Securities Exchange Act of 1934¹ and to propose, based upon the results of such examination, a new regulatory scheme of insider trading for Japan. The Article will concentrate on the questions of whether choosing section 16(b) as the mechanism for insider trading regulation was rational and whether section 16(b) has been functioning efficiently and equitably. It will also address the questions of what problems are posed by the dual regulation of section 16(b) and rule 10b-5² and what effect section 16(b) has on affording relief to victims of insider trading.

1. Section 16(b) provides: "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, or any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection." 15 U.S.C. § 78p(b) (1976).

2. Rule 10b-5 provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1978).

A cost-benefit analysis will be used to demonstrate that section 16(b) is an inefficient means of regulation.

The Japanese Securities Exchange Law (SEL)³ was modeled after the United States' Securities Act of 1933⁴ and the 1934 Act. The SEL, enacted while Japan was under the overwhelming influence of the World War II Occupation forces, remains largely operative today.⁵ Some branches of the tree of federal securities laws that was transplanted into Japanese soil have died without putting forth leaves while others have been pruned at the hands of the Diet primarily because of their incongruity with Japan's unique circumstances.⁶ The provisions dealing with insider trading regulation are among those that have died or have been pruned. Fortunately, however, the tree itself remains securely rooted.⁷

Recently in Japan, there has been pressure for fundamentally new legislation directed toward insider trading regulation.⁸ To the extent that this movement merely seeks to attain the fruits of American development, without first examining the process from which those fruits were derived, the necessity for insider trading regulation (from both a legal and an economic standpoint), and, if it is necessary, the appropriate type, optimal level, and enforceability of such regulation in the Japanese legal and social climate, the movement will not significantly improve Japan's current laws. It is the thesis of this

3. Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948 (amended 1971).

4. 15 U.S.C. §§ 77a-77aa (1976).

5. See A. Takeuchi, S. Michida, H. Maeda, M. Tatsuta & T. Tejima, *Gendai no Keizaikozo to Ho* 484 (1975) [hereinafter cited as A. Takeuchi & S. Michida]; M. Tatsuta, *Securities Regulation in Japan* 10-11 (1970); T. Suzuki & I. Kawamoto, *Shokentorihiki Ho* 20-22 (1968); Yazawa, *Nippon niokeru Kako oyobi Shorai no Shoken Kisei*, in 1 *Amerika To Nippon no Shokentorihiki Ho* 30-31 (L. Loss & M. Yazawa ed. 1975). See generally Fujita, *Shokentorihiki Ho chu Kubun to natteiru jakkan no Joko ni tsuite*, *Inbesutomento*, May-June 1961, at 2.

6. See K. Fujita, *Shokentorihikiseidoron* 1 (1962); Fujita, *supra* note 5, at 2-12.

7. See generally Kawamoto, *Shokentorihiki no kokusaika ni kansuru ichikosatsu*, in 1 *Gendaishohogaku no Kadai* 109 (Suzuki kokikinen ed. 1975); Yazawa, *supra* note 5, at 27-40.

8. Tatsuta, *Naibushatorihiki no Koka ni Kansuru Ripporonteki Kosatsu*, in *Kigyoho no Kenkyu* 698 (Osumi kokikinen ed. 1977) [hereinafter cited as *Ripporonteki Kosatsu*]; Tatsuta, *Naibushatorihiki ni Kansuru Horitsushian to Teianshushi*, 746 *Shojihomu* 1-9 (1976) [hereinafter cited as *Tatsuta Proposal*]. Professor Tatsuta's draft, which consists of twenty-three articles, is essentially an "insider trading regulation bill." Professor Tatsuta mainly referred to the Federal Securities Code of the American Law Institute as a model for his draft.

Other professors assert the necessity of new legislation treating insider trading regulation, but they do not actually propose a bill. See, e.g., Kanzaki, *Beikoku niokeru Naibushatorihikikisei no Hatten*, 74 *Minshoho Zasshi* 759, 802 (1976) (Federal Securities Code of the American Law Institute and the Corporate Securities Law of California are instructive); Takeuchi, *Naibushatorihiki: Soron*, 41 *Shoken Kenkyu* 133, 146-47 (1975) (Federal Securities Code of the American Law Institute is instructive); Yazawa, *supra* note 5, at 36, 37 (new legislation in Japan should be modeled after the Federal Securities Code of the American Law Institute and the Corporate Securities Law of California).

Article that section 16(b)-type regulation is inappropriate for Japanese as well as American society.

I. CONGRESSIONAL MISJUDGMENT

A. *Emotional Reaction*

A close investigation of the legislative history of section 16(b) of the 1934 Act reveals that Congress reacted emotionally and irrationally in the wake of the stock market crash—at least from the perspective of today's historians—in drafting the preventive measure for insider trading practices.⁹ In the climate of "native American radicalism"¹⁰ and in the furor over the crash, Congress sought the most drastic mechanism to deter insider trading practices. Thus, Congress, knowingly or unknowingly, chose the costly and harsh regulatory mechanisms of section 16(b) without considering the economic and legal ramifications.¹¹ Basically, section 16(b) provides that a director, officer, or ten percent beneficial owner who purchases and sells or sells and repurchases the stock of his corporation within a period of less than six months must account to the corporation for the profits he realizes.¹² Aiming for a dramatic effect, Congress erred in selecting this bootstrap regulatory method of lumping together the actual abuse of inside information and the nonuse of inside information in trying to prevent "the unfair use of information."¹³ This disparity between the end and the means is the source of section 16(b)'s efficiency defects.

Insider trading practices were rampant before the enactment of the 1934 Act. The theory of "caveat emptor" dominated as the only guiding principle of stock transactions.¹⁴ "Prior to the enactment of the Securities Exchange Act, profits from 'sure thing' speculation in the stocks of their corporations were more or less generally accepted by the financial community as part of the emolument for serving as a corporate officer or director notwithstanding the flagrantly inequitable

9. See 1 L. Loss, *Securities Regulation* 121 (2d ed. 1961). See generally Note, *An Economic Analysis of Section 16(b) of the Securities Exchange Act of 1934*, 18 Wm. & Mary L. Rev. 389, 389-90 (1976) [hereinafter cited as *An Economic Analysis*].

10. Loss, *The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States*, 33 Mod. L. Rev. 34, 37 (1970).

11. See generally Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 Colum. L. Rev. 260, 260 (1968). "It is hardly surprising that lawyers do not attach much, if any, weight to considerations of resource allocation when they direct their attention to securities markets problems. In their encounters with the securities markets, malfunctions loom large Of the millions of transactions that occur daily, the lawyer focuses on the few improper ones, and their importance in the market as a whole is magnified." Mendelson, Book Review, 117 U. Pa. L. Rev. 470, 470 (1969). See also Comment, *Section 16(b): Re-evaluation is Needed*, 25 U. Miami L. Rev. 144, 145 (1970) [hereinafter cited as *Re-evaluation*].

12. 15 U.S.C. § 78p(b) (1976), quoted at note 1 *supra*.

13. *Id.*

14. Loss, *supra* note 10, at 35.

character of such trading.”¹⁵ A survey by the New York Times reported that in 1915, ninety percent of business executives interviewed admitted to trading regularly in their own company's shares.¹⁶

After experiencing the crash of 1929, Congress had an extremely antagonistic attitude toward insider trading:

Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others.¹⁷

In reaching this view, Congress was furnished with extreme cases of insider trading to use as its basis of decision. In one case described in a report by the Committee on Banking and Currency, the president of a corporation and his brothers made a short-swing profit of approximately \$9 million.¹⁸ The example of Albert H. Wiggin, chairman of the Finance Committee of the Brooklyn-Manhattan Transit Corporation, had such a decisive influence upon Congress that the Committee on Interstate and Foreign Commerce went so far as to refer to the proposed section 16(b) as an “anti-Wiggin provision.”¹⁹ Wiggin, knowing in advance that a dividend was going to be passed, sold his block of 26,400 shares within a five-day period. After the dividend was passed, the market value of the stock declined sharply from a high of 25 to a low of 11½.²⁰ Another manipulative practice which incited Congress’ anger was pooling arrangements by insiders.²¹ An RCA pooling arrangement made \$5 million in only seven days.²²

Thus, of the millions of transactions that occurred daily, Congress focused on the few egregious ones and magnified their importance in

15. 10 SEC Ann. Rep. 50 (1944); see Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. Pa. L. Rev. 468 (1947).

16. H. Manne, *Insider Trading and the Stock Market* 2 (1966).

17. S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934), reprinted in 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 21, at 55 (1973).

18. S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934), reprinted in 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 17, at 9 (1973).

19. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934); see *Stock Exchange Practices, Hearings before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. 6555 (1934) [hereinafter cited as *Senate Hearings*]; *Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 Before the House Interstate and Foreign Commerce Comm.*, 73d Cong., 2d Sess. 134 (1934) [hereinafter cited as *House Hearings*].

20. *Stock Exchange Practices, Hearings on S. Res. 84 and S. Res. 56 Before the Comm. on Banking and Currency*, 73d Cong., 1st Sess. 3024-27 (1933).

21. S. Rep. No. 1455, 73d Cong., 2d Sess. 55-68 (1934), reprinted in 5 Legislative History of the Securities Act of 1933 and Securities Exchange Act of 1934, Item 21, at 55-68 (1973).

22. *An Economic Analysis*, *supra* note 9, at 393 n.17.

the market as a whole.²³ The basic misfortune in enacting the 1934 Act was that, having no experience in the legislation of securities laws, Congress had no cases for study other than the quite unusual practices before and after the stock crash. Congress, with input of unusual information, produced inadequate output.

B. *Misjudgment in Choosing a Regulatory Mechanism*

Historically, the most commonly used legal technique in the United States—and perhaps in other countries as well—to inhibit a type of conduct is to enact a provision declaring such conduct “unlawful” and to impose on a violator criminal penalties or administrative sanctions and/or civil damage liabilities. The compensatory damage mechanism is the most suitable method for resource allocation since it reallocates resources to the individuals to whom the resources should belong. The Sherman Act²⁴ utilizes this penalty-compensation mechanism in order to inhibit anticompetitive conduct.²⁵ Even the 1934 Act adopts the penalty-compensation mechanism as its general regulatory method.²⁶ In contrast, section 16(b) utilizes the automatic disgorgement mechanism as its sole method for inhibiting insider speculation. Thus, among the provisions of the Act, section 16(b) is an aberration.²⁷

It is quite logical to ask why Congress, instead of requiring forfeiture of the profits of insiders, did not explicitly make it unlawful for insiders to trade on the basis of undisclosed inside information,²⁸ and

23. See Mendelson, *supra* note 11, at 470.

24. 15 U.S.C. §§ 1-7 (1976).

25. For example, § 1 of the Sherman Act declares that “[e]very contract, combination . . . or conspiracy, in restraint of trade or commerce” is “illegal,” and imposes punishment by fine or imprisonment. *Id.* § 1. Under the Clayton Act, 15 U.S.C. §§ 12-27 (1976), any private person “injured in his business or property by reason of anything forbidden in the antitrust laws . . . shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney’s fee.” *Id.* § 15.

26. See, e.g., Securities Exchange Act §§ 5, 7(c), 7(f), 8, 9(a), 9(c), 9(e), 10, 12(a), 14(a), 14(b), 15, 16(c), 18(a), 20, 32(a), 15 U.S.C. §§ 78e, 78g(c), 78g(f), 78h, 78i(a), 78i(c), 78i(e), 78j, 78l(a), 78n(a), 78n(b), 78o, 78p(c), 78r(a), 78t, 78ff(a) (1976).

27. *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (“Section 16(b), it should be emphasized, embodies a rather uncommon regulatory mechanism.”).

28. Cal. Corp. Code § 25402 (West 1977), for example, provides: “It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.” *Accord*, ALI Fed. Securities Code § 1603(a) (Proposed Official Draft 1978).

provide for civil remedies, such as rescission or damages,²⁹ or criminal penalties.³⁰ This is a reasonable question in light of the congressional hearings which indicate that section 16(b) was specially designed to protect the outside stockholders against short-swing speculation by insiders with advance information.³¹

1. The Disgorgement Mechanism

The only theoretical ground offered by Congress to justify the disgorgement mechanism was a traditional agency principle: "[Section 16(b)] is simply an application of an old principle of the law that if you are an agent and you profit by inside information concerning the affairs of your principal, your profits go to your principal."³² This traditional agency principle rests on the notion that inside information is a corporate asset which may not be expropriated by an insider-agent for personal use.³³

The fundamental weakness of the corporate asset theory is that no valid rationale exists for allowing a principal to take away "the illegally acquired fruit" from an insider-agent. From a broad legal perspective, it seems unsound for a government to allow or encourage a person to enjoy profits unlawfully acquired by a third person. The counterargument is that so long as a principal-agent relationship exists, the duty of loyalty requires an agent to account for such profits to his principal.³⁴ But the question is not the propriety of this principle under the law of agency, but its propriety within the greater legal framework of society. Moreover, the agency principle alone cannot justify an accounting for profits when, as can occur under section 16(b), there is no actual use of inside information and hence no abuse of the principal's assets.

From the more narrow legal perspective of section 16(b), the theory that inside information is a corporate asset should be critically exam-

29. Cal. Corp. Code § 25502 (West 1977), for example, provides: "Any person who violates Section 25402 shall be liable to the person who purchases a security from him or sells a security to him for damages equal to the difference between the price at which such security was purchased or sold and the market value which such security would have had at the time of the purchase or sale if the information known to the defendant had been publicly disseminated prior to that time and a reasonable time had elapsed for the market to absorb the information, plus interest at the legal rate, unless the defendant proves that the plaintiff knew the information or that the plaintiff would have purchased or sold at the same price even if the information had been revealed to him." *Accord*, ALI Fed. Securities Code § 1703 (Proposed Official Draft 1978).

30. *See, e.g.*, Cal. Corp. Code § 25540 (West 1977); ALI Fed. Securities Code § 1821 (Proposed Official Draft 1978).

31. *See Senate Hearings, supra* note 19, at 6557-59; *House Hearings, supra* note 19, at 85.

32. *House Hearings, supra* note 19, at 133 (statement of Thomas G. Corcoran).

33. *Re-evaluation, supra* note 11, at 147; *see Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

34. W. Seavey, *Handbook of the Law of Agency* § 148, at 243-44 (1964).

ined. Assets must be characterized in terms of their value and usefulness to a corporation.³⁵ It is well established that section 10(b)³⁶ and rule 10b-5³⁷ prohibit a corporation from using inside information in the stock market.³⁸ In light of the fact that inside information has little value or utility to the corporation, the corporate asset theory seems to have lost one of its major underpinnings. Similarly, it cannot be said that insider trading usurps a corporate opportunity, since corporations are legally restricted from trading speculatively.

The agency theory is also inconsistent with the "lowest-in-highest-out" computation of profits adopted by the courts. Under this rule, when a defendant has engaged in a series of prohibited transactions at varying prices, the "profit" recoverable by the corporation is computed by matching the highest-price sales against the lowest-price purchases.³⁹ Because there is no provision for offsetting losses against profits, the defendant may be held liable for "profits" even when he has sustained an overall trading loss during the six-month period. Under the law of agency, however, "[a]n agent is under a duty to account to the principal for *any financial benefit* received by him as the direct result of a transaction conducted by him."⁴⁰ It naturally follows that the duty to account is invoked only when a positive benefit accrues to the agent, and that the agent owes the duty only to the extent of the actual benefit received. Thus, the lowest-in-highest-out rule is incompatible with the agency theory underlying section 16(b)'s disgorgement mechanism.

2. Automatic Liability

A careful examination of the language of section 16(b) and its legislative history reveals that Congress believed an objective standard of liability was the most effective means for arresting short-swing insider speculation.⁴¹ According to Thomas Corcoran, chief spokesman for the draftsmen and proponents of the section, it was purposely designed as a "crude rule of thumb"⁴² because of the overwhelming difficulty in proving that an insider intended, when he purchased stock

35. *Re-evaluation*, *supra* note 11, at 147.

36. 15 U.S.C. § 78j(b) (1976).

37. Rule 10b-5 is quoted at note 2 *supra*.

38. *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963); R. Jennings & H. Marsh, *Securities Regulation* 947 n.12 (4th ed. 1977); 6 L. Loss, *Securities Regulation* 3571 (2d ed. Supp. 1969); 3 L. Loss, *Securities Regulation* 1453 (2d ed. 1961).

39. *Gratz v. Claughton*, 187 F.2d 46, 50-52 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). See also *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959).

40. W. Seavey, *supra* note 34, § 148, at 243 (emphasis added).

41. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

42. *Senate Hearings*, *supra* note 19, at 6557.

in his company, to participate in short-swing speculation. Congress concluded that the efficiency of automatic liability outweighed its potential unfairness.⁴³ History, however, has proven section 16(b) to be an "extremely crude rule of a most deformed and misshapen thumb."⁴⁴ As the Second Circuit pointed out, "Congress decided in order to throw out the bathwater that the baby had to go too."⁴⁵

In summary, the structure of section 16(b) was built on a foundation of erroneous policy judgments. The most fundamental mistake was Congress' emotional reaction to the Great Crash. As a result, the congressional decision was based on the extreme and unusual cases of insider trading before and after the crash. In trying to achieve a dramatic deterrent effect, Congress did not adequately consider the economic effect, efficiency, function, and enforceability of the disgorgement mechanism. Moreover, without conducting a cost-benefit analysis or even considering economic ramifications, Congress designed the disgorgement mechanism to function automatically. This decision has led to dysfunctional and unfair results. Congress' failure to conduct a cost-benefit analysis was an egregious oversight. Such an analysis will now be used to demonstrate the folly of section 16(b).

II. A COST-BENEFIT ANALYSIS OF SECTION 16(b)

A. *A Framework for Analysis*

1. Optimal Regulation and Enforcement

To justify the regulation of an economic activity, two tests must be satisfied: (1) there must be a social need to regulate the activity; and (2) the activity should be regulated only to the extent needed. In other words, an appropriate regulatory scheme can be devised only after balancing the positive values of the economic activity against the negative values.

43. *Id.* at 6558; see *Bershad v. McDonough*, 428 F.2d 693, 696 (7th Cir. 1970) ("This [objective] approach maximized the ability of the rule to eradicate speculative abuses by reducing difficulties in proof."), *cert. denied*, 400 U.S. 992 (1971). The court in *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967), explained congressional intent in this way: "In order to insure discouragement of unfair insider short term trading *all* inside trading within a less-than-six-month period is discouraged. The arbitrary, some might say Draconian, nature of this statute reflects the view of experts who testified at the hearings leading to the passage of the 1934 Act that the unfair use of information by corporate insiders could only be effectively curbed by a law that made it unprofitable for insiders to engage in any short-term trading, whether fair or unfair. . . . In order so to insure that Section 16(b) efficaciously put an end to unfair insider trading, Congress explicitly made irrelevant the intent of any insider who engages in a short-term transaction, and did not condition the section's application on proof of an insider's intent to trade on a short swing." *Id.* at 515 (footnote omitted).

44. *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 331 F.Supp. 787, 792 (N.D. Cal. 1971), *aff'd*, 506 F.2d 601 (9th Cir. 1974), *aff'd*, 423 U.S. 232 (1976).

45. *Blau v. Lamb*, 363 F.2d 507, 515 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967).

As to the first test, which might be called a cost-benefit analysis at the level of necessity, a generally accepted notion is that "in deciding whether a legal regime should be adopted, it is necessary to identify and quantify benefits as well as costs."⁴⁶ When the benefits (B) which a society obtains from the economic activity are less than the cost (C^0), society feels a need for some regulation of the economic activity. This phenomenon is represented in the formula:

$$B < C^0$$

As the subjective term "feels" implies, a society may react to some extent on the basis of a moral or political judgment.

Under the second test, which may be called a cost-benefit analysis at the level of enforcement, four more costs should be considered: costs incurred by eliminating or diminishing the positive values of the economic activity (C^2); costs of enforcement (C^3);⁴⁷ costs of errors (C^4); and incidental costs (C^5). The costs of errors include both the risk of a regulation's being imposed on a person whose conduct does not violate the regulation⁴⁸ and the risk of a regulation's being automatically and indiscriminately applied to a person whose conduct is not harmful to the regulatory purposes. Another cost to consider is that, unless the regulation is completely effective, some amount of C^0 will remain (C^1).

When the two tests are considered together, a regulation can be justified only if the costs to society with regulation are less than the costs to society without regulation. Thus, a regulatory scheme should satisfy the following formula in which $C^1 + C^2 + C^3 + C^4 + C^5$ represents the total costs of regulation:

$$C^1 + C^2 + C^3 + C^4 + C^5 < C^0$$

The formula, however, does not indicate the optimal level of regulation. The cost of total enforcement (*i.e.*, $C^1 = 0$) is generally considered prohibitive.⁴⁹ "The goal of enforcement . . . is to achieve that degree of compliance with the rule of prescribed (or proscribed) behavior that the society believes it can afford."⁵⁰ Figure 1 illustrates that the

46. Schwartz & Tullock, *The Costs of a Legal System*, 4 J. Legal Stud. 75, 76 (1975).

47. *Id.*

48. *Id.*

49. *An Economic Analysis*, *supra* note 9, at 403. For a highly sophisticated and theoretical economic analysis of the present system of insider trading regulation, see Note, *A Framework for the Allocation of Prevention Resources with a Specific Application to Insider Trading*, 74 Mich. L. Rev. 975 (1976).

50. Stigler, *The Optimum Enforcement of Laws*, 73 J. Pol. Econ. 526, 526 (1970). Stigler states: "[T]here is one decisive reason why the society must forego 'complete' enforcement of the rule: enforcement is costly. *Id.* at 526-27.

"The extent of enforcement of laws depends upon the amount of resources devoted to the task. With enough policemen almost every speeding automobile could be identified. . . . Such a level of enforcement would of course be enormously expensive, and only in crimes of enormous impor-

optimal level of regulation occurs at P^1P . P represents the lowest point of costs and P^1 represents its corresponding degree of enforcement.

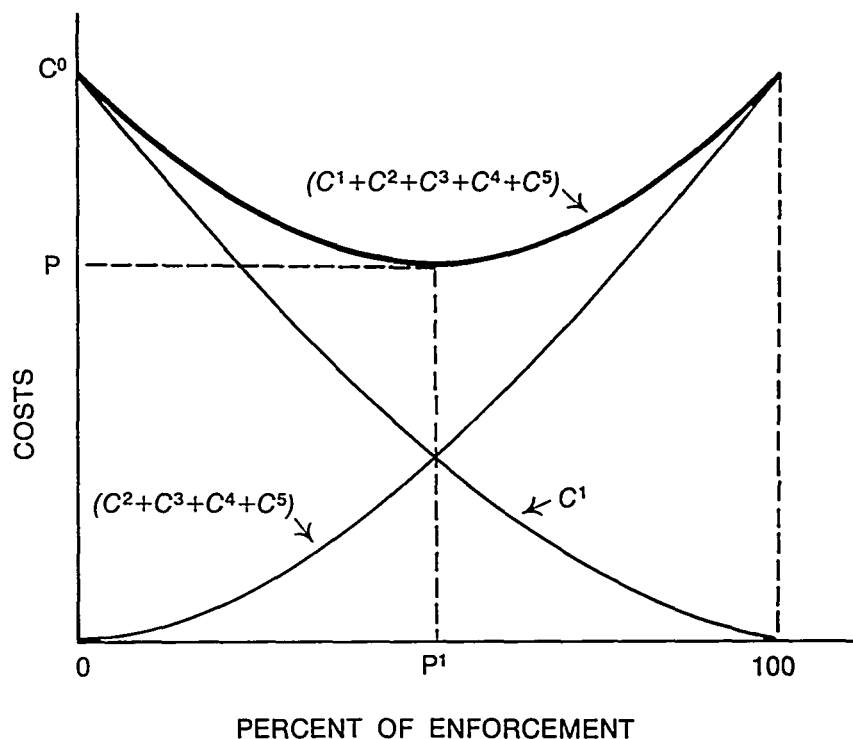


FIGURE 1

Figure 1 demonstrates that a departure from the optimal level of regulation, in either direction, necessarily entails greater total costs for society. The more complete and the stricter the regulatory scheme a society chooses, the greater the enforcement costs ($C^2 + C^3 + C^4 + C^5$) it must bear. Similarly, the looser the regulations a society has, the greater the benefit-related costs (C^1) it will have.

When benefits society derives from the economic activity (B) are taken into consideration, an enforcement range is created, within which the regulation is useful for society. The range will be referred to as the range of beneficial enforcement. The amount of benefits has been assumed to be a constant.

tance will such expenditures be approached. The society will normally give to the enforcement agencies a budget which dictates a much lower level of enforcement." *Id.* at 527. The article primarily discusses a criminal case, but the principle which it develops is also applicable to an economic regulation.

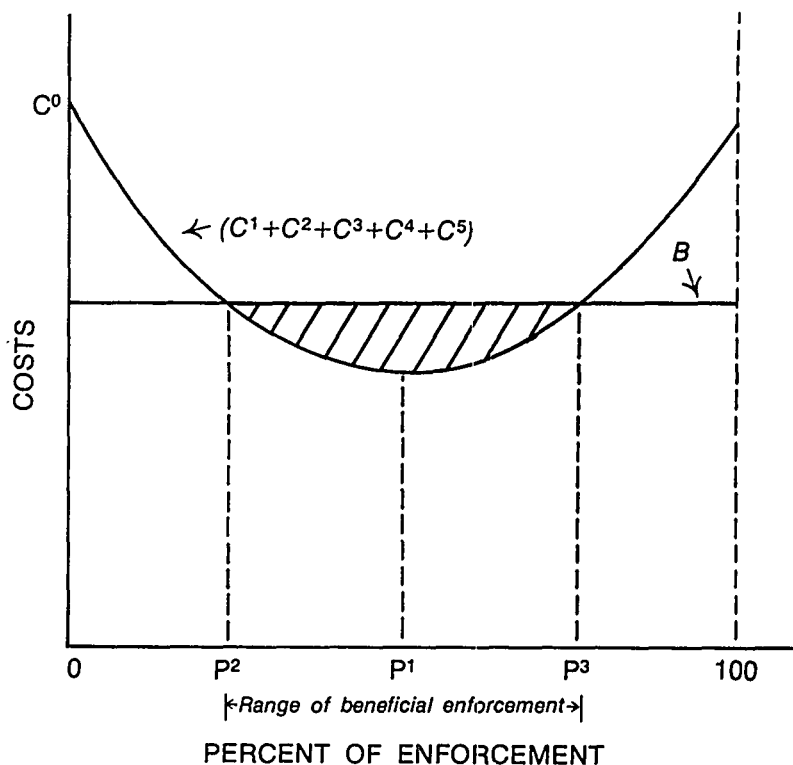


FIGURE 2

In Figure 2, P^2 - P^3 is the range of beneficial enforcement in which the benefits society derives from the economic activity exceed the costs of regulation. P^1 is the optimum level of enforcement. In the O - P^2 and P^3 -100 ranges, the costs of regulation exceed its benefits.

Society, however, does not necessarily behave solely on the basis of an economic rationalization.⁵¹ When a society adopts a legal regime, moral or political elements often play an influential role. A society may therefore act irrationally from an economic perspective; it may feel a necessity to regulate the economic activity beyond the optimum level of enforcement.⁵²

2. A Cost-Benefit Analysis of the Congressional Intent Underlying Section 16(b)

By rejecting the necessity of showing actual use of inside information, Congress intended to create a sweeping deterrent effect. In

51. See pt. I(A) *supra*.

52. On the economic study of law generally, see R. Posner, *Economic Analysis of Law* (2d ed. 1977). Posner also discusses the problem of "insider trading and entrepreneurial reward." *Id.* at 307-09.

reaching this result, however, Congress seemed to have had little regard for the economic ramifications of this draconian 100% enforcement. Of course, the six-month limitation on the enforcement of section 16(b) suggests that Congress took the harsh economic influence of the rule into consideration. Support for this argument can be found in a statement made by the Securities and Exchange Commission (SEC) thirty years after the enactment of section 16(b) that "[t]he provisions of section 16 do not interfere with an insider's investment transactions."⁵³ Moreover, the court in *Blau v. Max Factor & Co.*⁵⁴ noted that "Congress sought to minimize misuse of confidential information, without unduly discouraging bona fide long-term investment."⁵⁵ The argument, however, loses its force upon examination of the congressional records, which noticeably lack a careful consideration of the severe effects of 100% enforcement of the section *within* the six-month limitation.

There are two primary *ex post* explanations of the congressional intent underlying section 16(b). More than likely, Congress believed that short term insider trading was completely lacking inherent social benefit. Figure 3 represents a cost-benefit analysis of this explanation.

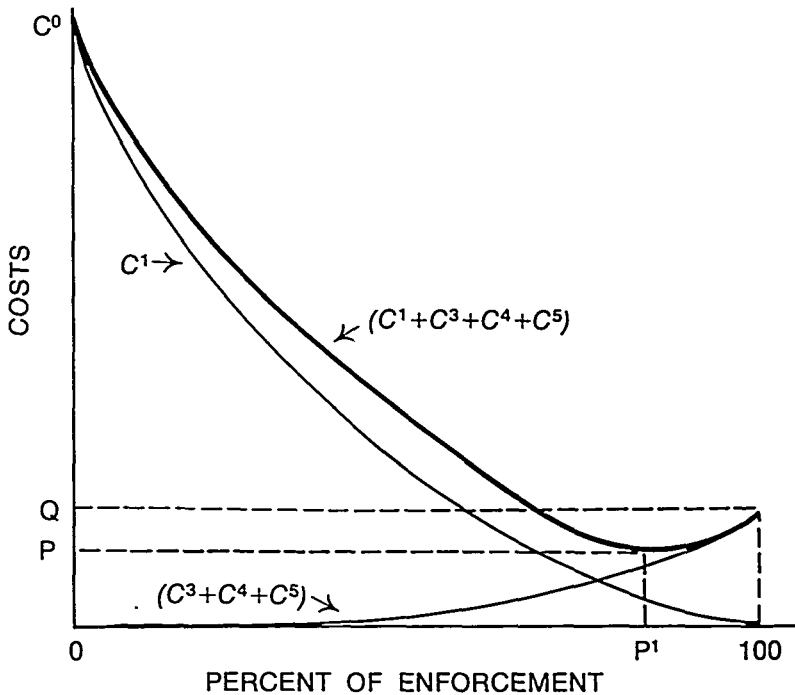


FIGURE 3

53. SEC Legislation, 1963: Hearings on S.1642 Before a Subcomm. of the Comm. on Banking and Currency, 88th Cong., 1st Sess. 400 (1963).

54. 342 F.2d 304 (9th Cir.), cert. denied, 382 U.S. 892 (1965).

55. *Id.* at 308.

The benefits (B) would equal zero and C^2 (the social costs caused by diminishing or negating the positive values associated with insider trading) would also equal zero. Furthermore, it is possible that Congress estimated the value of C^0 to be great, and the sum of C^3 , C^4 , and C^5 at 100% enforcement to be far less than the cost of no enforcement. The difference between Q (the cost of 100% enforcement) and P (the cost of optimal enforcement) would be quite negligible as compared to that between C^0 (the cost of no enforcement) and P .

Another explanation of congressional intent, perhaps more generous toward Congress, is that 100% enforcement was thought to be the most inexpensive method for society to prevent the abuses of insider information. Figure 4 represents a cost-benefit analysis of this *ex poste* explanation; B as well as C^2 would again equal zero. It is possible that Congress estimated the value of C^0 to be extremely high, and the sum of C^3 , C^4 , and C^5 at the point of 100% enforcement to not only be far less than the costs of no enforcement but also to be the most inexpensive cost of enforcement (P).

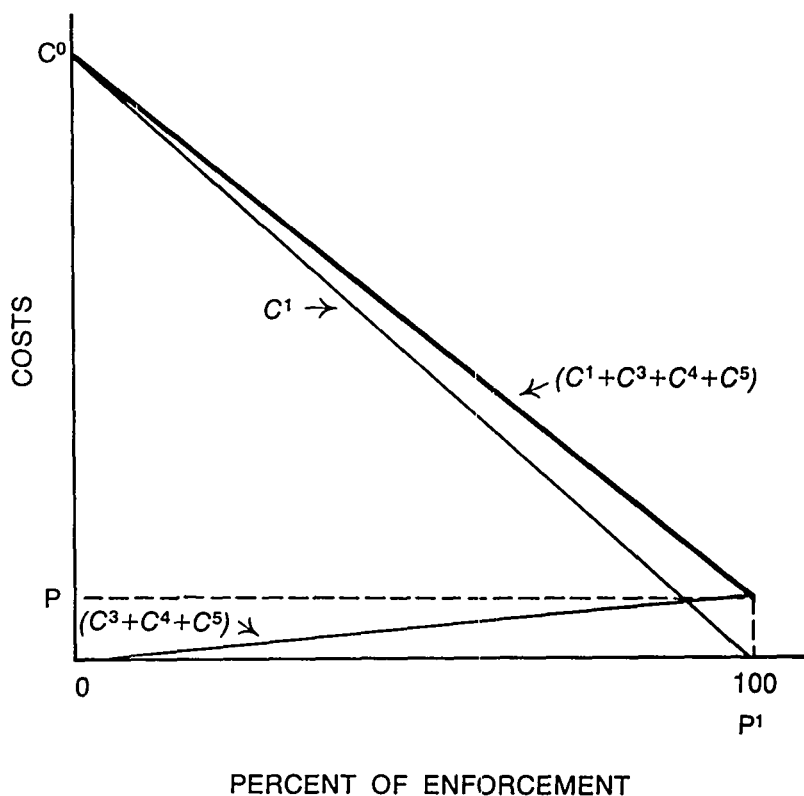


FIGURE 4

These cost-benefit analyses of congressional intent call for a careful examination of whether the congressional estimate of each cost is reasonable and whether there have been any changes in these costs due to later judicial developments. The questions to be addressed are: (1) whether insider trading truly has any inherent social benefit; (2) if it has, what are the social losses (C^2) caused by reducing or eliminating the positive values associated with insider trading; (3) whether the value of C^0 is as high as had been assumed;⁵⁶ (4) whether there was a congressional miscalculation with regard to C^3 ,⁵⁷ C^4 ,⁵⁸ and C^5 ,⁵⁹ and (5) whether section 10(b) and rule 10b-5 have rendered section 16(b) superfluous.⁶⁰ The following analysis of these questions leads to the conclusion that, contrary to *ex poste* assumptions of congressional intent, section 16(b) is a costly system for a society. One can persuasively argue that the regulatory scheme of section 16(b) far exceeds the optimal level of enforcement. It falls in the P^3 -100 range in Figure 2.

B. *The Positive Value of Insider Trading*

Economic activities have two facets: positive value and negative value. Regulation of economic activities leads to diminishing both the positive value and the negative value. Diminished positive value is, as mentioned earlier, one of the economic costs of regulation.⁶¹ The existence of the positive value of insider trading has been almost completely ignored, either intentionally or because of the overwhelming hostility towards such trading. There are, however, economists and scholars who recognize the positive value of insider trading.⁶² It is necessary to recognize the positive value of insider trading not because recognition supports nonregulation, but because regulation requires

56. See pt. II(B) *infra*.

57. See pt. II(C) *infra*.

58. See pt. II(D) *infra*.

59. See pt. II(E) *infra*.

60. See pt. II(F) *infra*.

61. Wu, *supra* note 11, at 269 ("We must know all of the costs and benefits of [the regulation], and the benefits from requiring equity between individual investors must justify any economic costs.").

62. Professor Manne is one of the leading defenders of insider trading. See note 64 *infra* and accompanying text. Commentators who recognize the positive value of insider trading include: Munter, *Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats,"* 52 Cornell L. Q. 69 (1966); Wu, *supra* note 11, at 269; Wu, *Corporate Insider Trading in the Stock Market, 1957-1961*, 2 Nat'l Banking Rev. 373 (1965) [hereinafter cited as *Corporate Insider Trading*]; *Re-evaluation*, *supra* note 11, at 155-56; Wu, *Letter to the Editor*, 45 Harv. Bus. Rev. 184 (1967) [hereinafter cited as *Letter*]; see Lorie & Niederhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J. Law & Econ. 35 (1968).

justification. Therefore, every conceivable value of the activity must be considered. It is imperative to emphasize that the following arguments are not being presented for the purpose of proposing the nonregulation of insider trading, but only for the purpose of completely examining section 16(b).⁶³

1. Stimulus to Innovation

Professor Henry Manne asserts, as his principal affirmative argument for insider trading, that "profits from insider trading constitute the only effective compensation scheme for entrepreneurial services in large corporations."⁶⁴ By "entrepreneur," he means an innovator, a person who finds a new idea and causes it to be put into effect. Innovation may be the invention of a new product, the reorganization of corporate administration, a corporate merger, or the selection and

63. Furthermore, this author does not agree with Professor Manne's argument that outsiders ultimately suffer no loss from insider trading practices. See H. Manne, *supra* note 16, at 93-110; Manne, *Insider Trading and the Law Professors*, 23 Vand. L. Rev. 547, 551-661 (1970) [hereinafter cited as *Insider Trading and Law Professors*]; Manne, *In Defense of Insider Trading*, 44 Harv. Bus. Rev. 113, 115 (1966) [hereinafter cited as *Defense*]. Manne relied entirely on Schumpeter's theory, which was not accepted by all economists. Manne also has been criticized by an economist for having missed the real economic issues. Letter, *supra* note 62. Professor Manne himself admits that he missed certain economic issues. *Insider Trading and Law Professors*, *supra*, at 565.

64. *Defense*, *supra* note 63, at 116; accord, H. Manne, *supra* note 16, at 131-46; *Insider Trading and Law Professors*, *supra* note 63, at 578-88. Professor Manne has contended that insider trading regulation is not necessary. H. Manne & E. Solomon, *Wall Street in Transition* (1974); H. Manne, *supra* note 16, at 93-110; *Defense*, *supra* note 63; see *Insider Trading and the Law Professors*, *supra* note 63; Manne, *Should Fund Managers Use Inside Information Personally? Yes*, Institutional Investor, May 1967, at 19. Despite theoretical support, this contention has been criticized. See, e.g., Kripke, Book Review, 42 N.Y.U. L. Rev. 212, 212 (1967).

Professor Jennings argues that Manne does not "come to grips with the social and political question whether the level of corporate amorality proposed by him would be tolerated by our society." Jennings, Book Review, 55 Calif. L. Rev. 1229, 1235 (1967). Professor Jennings, however, ignores the question of whether the present level of federal insider trading regulation under § 16(b) should be tolerated by our society. Professor Loss criticizes Manne's argument by writing that: "The grievous defect of the Manne thesis is his apparent scorn for the moral or public opinion factor . . ." 5 L. Loss, *Securities Regulation* 2999 (2d ed. Supp. 1969). Professor Painter concludes: "The answer . . . can scarcely be, as [Manne] would suggest, a return to laissez-faire; rather, it lies in a more enlightened and intelligible pattern of governmental regulation protecting the individual investor without significantly impairing individual initiative and resourcefulness." Painter, Book Review, 35 Geo. Wash. L. Rev. 146, 155 (1966).

Admittedly, insofar as Manne asserts that insider trading should be absolutely unfettered, he may be criticized for trying "to turn the clock back on legal developments over the last half century." Jennings, *supra* at 1229; see *Ripporonteki Kosatsu*, *supra* note 8, at 669. His economic approach to insider trading regulation, however, is worth re-evaluating for those who know the fallacy of § 16(b)-style regulation and who must try to prepare more equitable and reasonable regulatory methods. See Wu, *supra* note 11, at 261. Although Professor Wu criticizes some of Manne's economic analysis, *id.* at 260 n.3, he ultimately supports Manne's contention that the current regulation of insider trading may be harmful. *Id.* at 269; *Corporate Insider Trading*, *supra* note 62, at 373-81; Letter, *supra* note 62 at 186.

guidance of managers. The entrepreneur is therefore distinguishable from the manager who simply administers a business along lines already determined. Manne says that, "[t]o provide an effective incentive, entrepreneurial compensation has to be available when the benefits are realized by the corporation."⁶⁵ A salary or bonus is inappropriate, because both of them represent the market price for managerial skills, not the market price for entrepreneurial skills. Stock options and bonus plans provide some motivation for entrepreneurs, but not enough to take great personal risks.⁶⁶ According to Manne, "[i]f these [entrepreneurs] were to be limited to the same compensation as their dull unimaginative, and overly conservative predecessors, what incentive would they have to innovate?"⁶⁷

Of course, the idea of entrepreneurial compensation has been bitterly opposed by law professors.⁶⁸ Obviously, Manne's attempt to justify insider trading by relying on the idea of entrepreneurial compensation is understandable only as a sort of political ideology for the survival of a capitalistic dynamics, and not as a sophisticated legal theory. Nevertheless, for the purposes of the cost-benefit analysis it should be recognized that insider trading has some effect in stimulating entrepreneurial activities. It is difficult to argue with Manne's contention that the greater the compensation offered for performing an activity, the greater the level of activity.⁶⁹ The cost-benefit analysis of this Article poses the serious question of whether section 16(b) protects the investor without significantly repressing individual ingenuity.

2. Liquidity

The function of a securities market is to facilitate the flow of savings from the public to industry and the changes in the asset composition of investors.⁷⁰ The advantage of equity investment for investors is liquidity. Because of the existence of securities markets, investors can withdraw their invested funds by selling their stocks at any time on the markets at a reasonable price. The reduction of investment risk

65. *Defense*, *supra* note 63, at 117 (emphasis added).

66. *Id.* at 119.

67. *Id.*

68. Hetherington, *Insider Trading and the Logic of the Law*, 1967 Wis. L. Rev. 720, 730; Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1457 (1967); Jennings, *supra* note 64, at 1233-35; Kripke, *supra* note 64, at 216-17; Painter, *supra* note 64, at 152-60.

69. *Insider Trading and Law Professors*, *supra* note 63, at 582. Judge Learned Hand aptly stated: "I conceive that the law allows a director to increase his stake in the company, because it adds to his incentive to make it succeed; the greater the prize, the greater the effort; it will dampen his zeal, if his holdings must be frozen at what he has when he is elected." *In re Calton Crescent, Inc.*, 173 F.2d 944, 952 (2d Cir.) (L. Hand, J., dissenting), *aff'd sub nom. Manufacturers Trust Co. v. Becker*, 338 U.S. 304 (1949).

70. Letter, *supra* note 62, at 184.

provided by liquidity thus attracts more investors to equity investment. Therefore, "[t]he degree of success of a stock market in fulfilling its promotional function—facilitating optimum saving-investment flows—depends largely on its ability to provide liquidity."⁷¹ A liquid market always has enough potential buyers to meet the demands of potential sellers. Thus, the price of stocks transacted in a liquid market is stable.

According to classical economic theory, liquidity is fostered by speculation which provides "an active and broad market," and reduces "intertemporal differences in price."⁷² For the classical economists, speculators are those who have better-than-average foresight and know the normal price in the market. Speculators tend to "buy when the current price is below normal and [to] sell when it is above normal," thus stabilizing prices.⁷³

Corporate insiders frequently have been regarded as successful speculators. The following testimony, before the House Committee on Interstate and Foreign Commerce, which was then considering the repeal of section 16(b), was offered to explain why corporate insiders make good speculators:

[S]ection 16(b) has driven out of the market the best informed buyers and sellers, those whose valuation of the security should be the soundest. It has driven out of the market those who would be most interested in preserving an orderly, stable, liquid market for their company's securities. It has driven out of the market those who would be most interested in protecting their company's securities from sudden and unreasonable price fluctuations and who would be a great stabilizing influence in times of stress. All in all, it is an unintelligent and unreasonable restriction upon the normal forces of supply and demand. It is inconsistent with the sound concept of a free and open market and operates to the detriment of investors and the quality of the market.⁷⁴

Furthermore, the President of the San Francisco Stock Exchange, representing the viewpoint of regional stock exchanges, argued that section 16(b) was detrimental to regional exchange markets.⁷⁵ According to his argument, a large number of the companies having securities listed on a regional exchange are family or close corporations, and a substantial percentage of the shares almost universally remain in the hands of the former owners even after listing. He alleged:

In such cases, to set up limitations upon the purchase and sale of securities of these companies which may deprive the market of support in times of stress, or eliminate the

71. Wu, *supra* note 11, at 263.

72. *Id.* at 265.

73. *Id.*

74. *Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934: Hearings on H.R. 4344, H.R. 5065, H.R. 5832 Before the House Comm. on Interstate & Foreign Commerce, 77th Cong., 1st Sess. 1415 (1947) [hereinafter cited as *Proposed Amendments*] (statement of William B. Putney III).*

75. *Id.* at 1318 (statement of Sidney L. Schwartz).

supply of stock, is an act which can be harmful to the interests of the public and specifically to the interests of the company's stockholders. Obviously, the limitation of action such as is implicit in section 16(b), on the part of officers, directors, and principal stockholders of small local companies is much more harmful to the public interest than it is in the case of companies with Nation-wide security distribution.⁷⁶

In 1941, concern over the adverse economic effects of section 16(b) prompted representatives of the securities industries to draft proposals for repeal of the section. Although these industry proposals were extreme in concluding that "the disclosure provision of Section 16(a) and the prohibition of short sales contained in Section 16(c) are effective deterrents to the unfair use of inside information and that further deterrents are unnecessary,"⁷⁷ the reasons offered for repeal of section 16(b) are worth considering. The proposals noted that an insider who buys the stock of his company to prevent a sudden or unreasonable decline must face, in addition to the risk of loss, confiscation of any profit.⁷⁸ The industry proposals concluded that it was difficult to calculate the "extent [to which section 16(b) had] contributed to the non-liquid character of markets . . . or to the sudden fluctuations in security prices. However, so long as this provision remains in the law the most reliable sources of market support in times of stress will for all practical purposes remain closed."⁷⁹ They also concluded that the defects of section 16(b) eclipse its benefits.⁸⁰

Empirical studies verify that corporate insiders are speculators who create liquidity. One study of insider trading from 1950 to 1960 using a

76. *Id.* at 1320 (statement of Sidney L. Schwartz).

77. Investment Bankers Association of America, National Association of Securities Dealers, Inc., New York Curb Exchange, and New York Stock Exchange, Report on the Conference with the Securities and Exchange Commission and Its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934, at 263 (1941) [hereinafter cited as Industry Proposals]. *But see* 66 ABA Ann. Rep. 356-57 (1941). Section 16(a) is quoted at note 188 *infra*.

Section 16(c) of the 1934 Act provides: "It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal (1) does not own the security sold, or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense." 15 U.S.C. § 78p(c) (1976).

78. Industry Proposals, *supra* note 77, at 261.

79. *Id.*

80. *Id.* Since the Industry Proposals, there has been a continuing demand for § 16(b)'s repeal. *Part 2 Investor Protection: Hearings on H.R. 6789, H.R. 6793, S. 1642 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 88th Cong., 1st & 2d Sess. 1201 (1963-1964)* (letter from William L. Cary). For example, the Committee on Securities Regulation of the Association of the Bar of the City of New York proposed to reduce substantially the scope of § 16(b). *Id.*

stratified random sample of 105 New York Stock Exchange companies concluded that "[i]nsiders tend to buy more often than usual before large price increases and to sell more than usual before price decreases."⁸¹ The study also concluded that "the skill of insiders in forecasting large price changes is demonstrated."⁸² Another empirical study by an economist provides further evidence suggesting that insider trading, at least in the long run, may be price stabilizing.⁸³

3. Allocational Efficiency

Another important function of the securities market is to facilitate the flow of savings to the most productive industries. "A well-performing capital market will allocate a given volume of savings in such a way that those industries with the highest prospective rates of return will receive the greatest amounts."⁸⁴ For this purpose, the price mechanism of securities markets must be allowed to function fully. Only in markets where a fair price determination is being made do stock prices "reflect the 'intrinsic values' of the companies."⁸⁵ In order to realize a fair price determination, the markets must have full access to information about companies. It is arguable that complete and constant disclosure of information by companies is, practically speaking, infeasible. There are many factors that will always prevent the achievement of full disclosure.⁸⁶ For example, stock exchange guidelines for timely disclosure are not legal obligations. It has also been argued that it is legally permissible for a company to withhold material information from the public under certain circumstances.⁸⁷ Thus, commentators have recognized the important role of insiders as forecasters; by channeling additional information into the market through their trading activities, insiders increase the likelihood of fair price determination.⁸⁸

C. *Problems in Enforcing a Disgorgement Mechanism by Private Litigation: An Enforcement Cost*

Congress thought that private plaintiffs would aggressively bring section 16(b) suits, and relied on the deterrent effect of private action to compensate for the limited manpower and budget of the SEC. As Thomas Corcoran reported to Congress: "[Y]ou have made the stock-

81. Lorie & Niederhoffer, *supra* note 62, at 52.

82. *Id.* at 47.

83. *Corporate Insider Trading*, *supra* note 62, at 381-82.

84. Letter, *supra* note 62, at 186.

85. Wu, *supra* note 11, at 264 (footnote omitted)

86. See *Insider Trading and Law Professors*, *supra* note 63, at 569-74.

87. Williams, *Corporate Publicity*, in *Fourth Annual Institute on Securities Regulation* 391, 393-96 (1973).

88. Wu, *supra* note 11, at 266; Letter, *supra* note 62, at 186.

holders your policemen."⁸⁹ It may be true that without the efforts of private plaintiffs, the SEC would have an onerous burden in enforcing the securities laws.⁹⁰ The problem with this view, however, is that private litigants generally will act as policemen only when there is a private profit or other incentive for bringing a suit. A private damage suit can provide such an incentive.⁹¹ The Supreme Court, in *J.I. Case Co. v. Borak*,⁹² noted: "As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon."⁹³

The disgorgement mechanism of section 16(b), however, provides little or, in most cases, no incentive for individual shareholders to bring a suit for forfeiture of profits, the recovery of which will inure to the corporation. The shareholders' benefit, if any, would only be an incidental pro rata share of the increase of corporate assets.⁹⁴ It is not surprising, then, that from 1934 to 1951 only thirty-one section 16(b) actions were commenced.⁹⁵ The lack of shareholder interest in section 16(b) for almost two decades after its enactment reflects the inherent weakness of the statute as an enforcement tool.⁹⁶

In recent years, attorneys have gravitated toward section 16(b) cases because of the allurements of high fees in such actions. One commentator has said that "[l]iberal rulings with respect to attorney's fees have made the members of the bar section 16(b)'s policemen."⁹⁷ This

89. *House Hearings*, *supra* note 19, at 136. Corcoran clearly made a mistake in overestimating the private incentive given to the shareholders under § 16(b) when he stated: "The fact that the stockholders, with an interest, are permitted to sue to recover that profit for the benefit of the company, puts anyone doing this particular thing, in the position of taking risk that somebody, with a profit motive will try to find out. The section is a deterrent, and you will in some cases actually catch violators." *Id.* at 137.

90. Lundquist, *Private Civil Action* (pt. 1), in *Enforcement and Litigation Under the Federal Securities Laws* 111, 124 (1970). As to the function of private litigation under the securities law, see K. Kanzaki, *Shokentorihikikisei no Kenkyu* 150-53, 161-64 (1969); Cohen, *The Development of Rule 10b-5*, 23 *Bus. Law.* 593, 597 (1968); Pitt, *An SEC Insider's View of the Utility of Private Litigation Under the Federal Securities Laws*, 5 *SEC Reg. L.J.* 3 (1977).

91. "The policies underlying the securities laws are enhanced by permitting private recoveries as the possibility of these recoveries is a deterrent to violation of the laws." Lundquist, *supra* note 90, at 124.

92. 377 U.S. 426 (1964).

93. *Id.* at 432.

94. *Re-evaluation*, *supra* note 11, at 160.

95. *See id.*

96. *See id.*

97. *Re-evaluation*, *supra* note 11, at 160 n.91. The Second Circuit has stated that "[s]ince in many cases such as this the possibility of recovering attorney's fees will provide the sole stimulus for the enforcement of § 16(b), the allowance must not be too niggardly." *Smolowe v. Delendo Corp.*, 136 F.2d 231, 241 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). It is not uncommon for the award of attorney's fees to be 50% of the sum recovered. 2 L. Loss, *Securities Regulation* 1052 (2d ed. 1961). For example, the plaintiffs' attorney in *Grossman v. Young*, 70 F. Supp. 970 (S.D.N.Y. 1947), was awarded a fee of \$42,500 out of a total recovery of \$85,000. For cases which have allowed liberal attorney's fees, see 2 L. Loss, *supra*, at 1052 nn.70 & 71.

tendency, however, should be subject to critical scrutiny.⁹⁸ Some courts have attempted to analyze the problem of attorneys policing section 16(b) by balancing the necessity to regulate insider trading against the evils of champerty.⁹⁹ The problem, however, is multifaceted. First, large attorney's fees themselves constitute a social cost which society must bear.¹⁰⁰ Second, awarding attorney's fees—which are essentially a part of the insiders' illegal profit—is a mis-reallocation of social resources because while the attorney benefits, the injured outsider-shareholder remains uncompensated. Third, payment of attorney's fees dissipates the insider's resources thereby impeding recovery by injured parties in a section 10(b) suit.¹⁰¹

D. Cost of Errors

The cost of errors (C^4) is inevitable under section 16(b). Congress anticipated this cost when it chose the 100% automatic enforcement mechanism.¹⁰² Congress' failure was its underestimation of the cost. The effect of section 16(b) is to eject from the markets every instance of insider trading which falls within the six month limitation, regardless of whether the trading is actually harmful to the regulatory purpose. To apply the sanction to innocent persons is itself a social cost (C^4). In addition to this cost, the secondary costs incurred by such an erroneous application may be even more serious to society. This, in other words, raises "the serious economic question of whether the public interest is not better served by having a buyer or seller even though he be an insider than to have no buyer or no seller."¹⁰³

98. "[T]he issuer may conclude that the action has been commenced not for the benefit of the issuer or its shareholders, but primarily to gain a fee for the security holder's attorney." Comment, *Insider Trading: The Issuer's Disposition of an Alleged 16(b) Violation*, 1968 Duke L.J. 94, 103-04.

99. See *Magida v. Continental Can Co.*, 176 F. Supp. 781, 783 (S.D.N.Y. 1956).

100. Professor Loss urges that the SEC should take a more active enforcement role in order to mitigate this cost. 2 L. Loss, *Securities Regulation* 1053-54 (2d ed. 1961); see 5 L. Loss, *Securities Regulation* 3017-21 (2d ed. Supp. 1969). In this connection it is interesting to note the province of Ontario concluded in 1965: "This simplified derivative action has the result in the United States of inducing persons, usually lawyers, to cause these actions to be instituted for the purpose of obtaining legal fees. This is an unseemly procedure . . . and we do not recommend its adoption in Ontario. . . . In order to provide the effective remedy which we feel is necessary, a governmental agency should have the right to bring the action if the company fails to do so within a reasonable time. The Ontario Securities Commission is the logical agency to assume this responsibility." Att'y Gen. Comm. on Securities Legislation in Ontario ¶¶ 2.28-.29 (1965), quoted in Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure*, 21 Bus. Law. 193, 208 (1965).

101. The Federal Securities Code of the American Law Institute provides that the profit paid to the issuer is recoverable by the insider to avoid double liability. ALI Fed. Securities Code § 1714(i) (Proposed Official Draft 1978).

102. See pt. I(A) *supra*.

103. *Proposed Amendments, supra* note 74, at 1341 (statement of Kenneth L. Smith).

E. *Inefficiency, Inequity, and Unpredictability of the Automatic Disgorgement Mechanism: Incidental Costs*

Congress imposed three basic limitations on the use of section 16(b). First, an insider transaction must fall within a six-month period to be a target of section 16(b).¹⁰⁴ Second, an insider must be a director or an officer or a ten percent beneficial shareholder of the issuing corporation to come within section 16(b) coverage. Third, an insider-shareholder must hold ten percent or more of the shares of the issuing corporation, both at the time of the purchase and at the time of the sale, to be a section 16(b) target.

The rationale for imposing these restrictions seems to be that the section's automatic weapon cannot be used without appropriate restraints because its destructive power is indiscriminate.¹⁰⁵ Additionally, "[t]he narrower the class of potential defendants, the greater the probability of holding insiders liable."¹⁰⁶ Unfortunately, as one commentator suggests, these rigid limitations are conducive to evasion by shrewd insiders.¹⁰⁷ Accordingly, it is quite possible that the efficiency of section 16(b)'s rigid limitations is unavoidably circumscribed.

The limitations also cause an inequitable imbalance between those insiders who fall just inside a limitation and those who fall just outside,¹⁰⁸ even though there may be no essential difference between the acts of either. Section 16(b), then, functions only as a "trap for the unwary,"¹⁰⁹ for it catches the pitiable "minnows" while letting the more clever and crafty "big fish" escape.¹¹⁰

Despite its rigidity, section 16(b) is frequently ambiguous because Congress failed to anticipate adequately and provide for the wide variety of forms insider trading can take. Contrary to congressional expectation, "grey targets," whose outward appearances do not indicate whether they fall inside or outside of the line, have emerged. Inequity between indisputable inside targets and grey targets has arisen. In addition, the grey targets have been placed in an insecure position, thus impairing the legal stability of society and the predictability of economic transactions.

104. For a thorough analysis of the rationale of the six-month limitation period and its application to actual situations, see Comment, *Section 16(b): An Alternate Approach to the Six-Month Limitation Period*, 20 U.C.L.A. L. Rev. 1289 (1973).

105. See notes 10-13 *supra* and accompanying text.

106. *An Economic Analysis*, *supra* note 9, at 409.

107. *Id.*

108. *Id.* at 412.

109. *Id.* at 411 (footnote omitted); accord, R. Jennings & H. Marsh, *supra* note 38, at 1173.

110. Munter, *supra* note 62, at 72, 74.

1. Section 16(b) Limitations: Their Inherent Ambiguity, Inequity, and Inefficiency

a. The Six-Month Limitation

An insider who purchases stock and sells it exactly six months later (e.g., a purchase at 8:00 a.m. on January 15 followed by a sale at 4:00 p.m. on July 14 would be a transaction of exactly six months) is not within the statutory period of "less than" six months¹¹¹ and is therefore not a target of section 16(b), while an insider who sells just one day earlier (e.g., at any time on July 13)¹¹² is subject to the section. If the latter insider has not actually used inside information while the former insider has, the inequitable imbalance is obvious. The speculative value of inside information would never become obsolete by the passage of just one day unless there is a public disclosure of the information. Although "ordinarily the useful life of 'confidential' inside information is brief,"¹¹³ it is very likely that inside information concerning mergers, new technological developments, or oil or metal resource discoveries probably will survive for more than six months.¹¹⁴ Thus, the section can never preclude the opportunity for making a profit by using inside information.

b. The Status of the Insider Limitation

Under section 16(b), only persons who have the status of either "director," or "officer," or "ten percent beneficial owner" can be targets of liability. One of the most significant sources of inefficiency and inequity under this limitation is that such insiders can evade liability and pocket virtually all of the speculative profit by tipping off their confidants.¹¹⁵ Here again, section 16(b) functions only as a fishing net for minnows.

c. The Ten Percent at Times of Purchase and Sale Limitation

(i) *The Ten Percent Limitation*: This limitation has functioned as a guidepost by which insiders can evade liability under section 16(b), thus demonstrating the inefficiency of the automatic mechanism. In *Reliance Electric Co. v. Emerson Electric Co.*,¹¹⁶ the defendant Emer-

111. R. Jennings & H. Marsh, *supra* note 38, at 1211.

112. *Id.*

113. *Blau v. Max Factor & Co.*, 342 F.2d 304, 308 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965).

114. *See, e.g., SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

115. The original draft of § 16(b) provided that tipping or exchanging activity would be unlawful and that any profit made by such activity would be recoverable by the issuer. H.R. 7852, 73d Cong., 2d Sess. § 15(b), 78 Cong. Rec. 2378 (1934).

116. 404 U.S. 418 (1972).

son Electric Co., the owner of 13.2% of a corporation's shares, disposed of its entire holdings in a split-sale, with both sales occurring within six months of purchase. The first sale reduced the defendant's holdings to 9.96% and the second disposed of the remainder. The Supreme Court held that the profits derived from the second sale were not recoverable by the corporation under section 16(b).¹¹⁷ Although the ten percent limitation was used as a guidepost for escaping liability, the Court stated that "[l]iability cannot be imposed simply because the investor structured his transaction with the intent of avoiding liability under §16(b)."¹¹⁸

By using split-sales, a beneficial owner can retain practically all of the speculative profits. In addition, he does not have to separate his purchase and sale by six months or more. Thus, by repeating this trick during the useful life of the inside information, the beneficial owner can make a large profit while having to disgorge only a very slight portion of it.

(ii) *The Timing of the Ten Percent Limitation*: The Supreme Court, in *Foremost-McKesson, Inc. v. Provident Securities Co.*,¹¹⁹ held that the purchase of securities by an insider who, for the first time, becomes a more than ten percent beneficial owner is not covered by section 16(b).¹²⁰ Thus, insiders no longer have to go to the trouble of splitting their sales in order to avoid liability. They can simply sell their entire holdings in one sale, and no disgorgement will be required. By sanctioning an even more profitable way for escaping liability than previously existed under *Reliance Electric*, *Foremost-McKesson* has savagely extracted the teeth out of section 16(b). To understand the combined result of these two cases consider the series of transactions set out in Table 1 below.¹²¹

TRANSACTION	% OF SHARES TRADED	TOTAL % OWNED BY INSIDER	DATE
Purchase	12	12	May 1
Purchase	5	17	July 1
Sale	7.0001	9.9999	Sept. 1
Sale	9.9999	0	Sept. 5

TABLE 1

117. *Id.* at 420.

118. *Id.* at 422.

119. 423 U.S. 232 (1976).

120. Section 16(b) provides that the section shall not be construed to cover any transaction in which the beneficial owner was not such "at the time of" both the purchase and sale of the securities involved. The issue was whether the words "at the time of" mean prior to or simultaneous with. *Id.* at 235.

121. This table is based on an example in R. Jennings & H. Marsh, *supra* note 38, at 1189.

An insider who followed the above series of transactions would be liable only for the profit realized on shares purchased on July 1 that were sold on September 1. The May 1 purchase would not be considered because the insider was not a ten percent holder prior to that purchase and the September 5 sale would not be considered because the insider was not a ten percent holder either prior to or after that sale.¹²²

2. "Grey Targets": Inequity and Instability

The emergence of grey targets has shattered the congressional dream that the rigid structure of section 16(b) would make its automatism highly efficient.¹²³ To determine whether these grey targets are covered by the section, courts have been forced to inquire into the subjective substance of the grey targets.¹²⁴ Inequity between orthodox targets and grey targets has been created because orthodox targets are automatically liable under section 16(b) whereas grey targets are subject to section 16(b) only if an examination of the circumstantial facts of the transaction reveals a possibility of speculative abuse of inside information.¹²⁵ The inquiry into subjective substance has also caused arbitrary application of the section. As one commentator precisely indicated, "the 'possibility of abuse' test is vague enough to allow divergent conclusions from the same facts."¹²⁶ Since liability is automatic under section 16(b), inequity and arbitrariness have engendered serious legal instability.

a. "Purchase" and "Sale"

The use of the terms "purchase" and "sale" has produced many perplexing grey targets. Congressional definitions of these terms in the statute¹²⁷ were too simple and abstract to be adequate guidelines for determining whether a particular grey target was within the purview of the section. A few problematical grey targets are: conversions,¹²⁸

122. *Foremost-McKesson* concerned only purchase-sale transactions. The Supreme Court has yet to choose its policy concerning sale-repurchase transactions and there is considerable disagreement among the lower courts on this point. Compare *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) with *Provident Sec. Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *aff'd*, 423 U.S. 232 (1976); *Emerson Elec. Co. v. Reliance Elec. Co.*, 434 F.2d 918 (8th Cir. 1970), *aff'd*, 404 U.S. 418 (1972); *Stella v. Graham-Paige Motors Corp.*, 104 F. Supp. 957 (S.D.N.Y. 1952), *aff'd*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956) and *Stella v. Graham-Paige Motors Corp.*, 232 F.2d at 302 (Hincks, J., dissenting).

123. See notes 41-43 *supra* and accompanying text.

124. See notes 134, 144, 149, 152, 156 *infra* and accompanying text.

125. See notes 149, 152, 160 *infra* and accompanying text.

126. *An Economic Analysis*, *supra* note 9, at 401.

127. See Securities and Exchange Act § 3(a)(13), (14), 15 U.S.C. §§ 78c(a)(13), (14) (1976).

128. See 17 C.F.R. § 240.16b-9 (1978); SEC Securities Exchange Act Release No. 7826 (Feb. 17, 1966), reprinted in [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,329.

transfers of shares in connection with mergers or consolidations,¹²⁹ reclassifications of stock,¹³⁰ options,¹³¹ and gifts.¹³² These transactions are different in character than the orthodox cash-for-stock transactions. In wrestling with these unorthodox grey targets,¹³³ the majority of courts have taken the pragmatic approach by examining subjective elements of a transaction to decide whether it is a target of section 16(b).¹³⁴ On the other hand, the minority view of the courts is to take an objective approach, refusing to analyze the subjective nature of a transaction.¹³⁵ The existence of two approaches, which conflict in both their philosophies and ramifications,¹³⁶ is itself the source of perplexity and confusion.¹³⁷

b. Status of Insider

(i) *Director*: Section 3(a)(7) of the 1934 Act defines the term "director" as "any director of a corporation or any person performing

129. Compare *Newmark v. RKO Gen., Inc.*, 425 F.2d 348 (2d Cir. 1970) ("objective" pragmatic approach), *cert. denied*, 400 U.S. 854 (1970) with *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973) ("medium" pragmatic approach), and *Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973) ("subjective" pragmatic approach), *cert. denied*, 419 U.S. 873 (1974). Each court took a pragmatic approach. The comparison of these three cases reveals that a pragmatic approach leads to arbitrary results, thereby creating legal instability.

130. *Roberts v. Eaton*, 212 F.2d 82, 84-85 (2d Cir. 1954).

131. See *Steinberg v. Sharpe*, 95 F. Supp. 32 (S.D.N.Y. 1950); *cf.* *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 602 (1973) (option agreement in question did not offer "measurable possibilities for speculative abuse"). But see *Bershad v. McDonough*, 428 F.2d 693 698 (7th Cir. 1970), *cert. denied*, 400 U.S. 992 (1971). 17 C.F.R. § 240.16a-6(b) (1978) provides in pertinent part: "For the purpose of section 16(a) of the Act both the grantor and the holder of any presently exercisable put, call, option or other right or obligation to buy or sell securities shall be deemed to be beneficial owners of the securities subject to such right or obligation until it is exercised or canceled or expires."

132. Mere gifts of securities do not constitute sales. See, e.g., *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948). But see *Lewis v. Adler*, 331 F. Supp. 1258, 1267 (S.D.N.Y. 1971); 17 C.F.R. § 240.16a-9(b) (1978).

133. See generally 5 L. Loss, *Securities Regulation* 3027-48 (2d ed. Supp. 1969); 2 L. Loss, *Securities Regulation* 1066-84 (2d ed. 1961).

134. See, e.g., *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974); *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), *cert. denied*, 385 U.S. 1006 (1967); *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Blau v. Max Factor & Co.*, 342 F.2d 304 (9th Cir.), *cert. denied*, 382 U.S. 892 (1965); *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), *cert. denied*, 359 U.S. 927 (1959); *Roberts v. Eaton*, 212 F.2d 82 (2d Cir. 1954).

135. See, e.g., *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972); *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968).

136. For the study of these two approaches, see Lowenfels, *Section 16(b): A New Trend in Regulating Insider Trading*, 54 Cornell L. Rev. 45 (1968).

137. Comment, *Section 16(b): Judicial Inconsistency in Application of the Pragmatic Approach*, 5 Tex. Tech. L. Rev. 731, 748 (1974).

similar functions with respect to any organization, whether incorporated or unincorporated."¹³⁸ Unfortunately, however, this definition is too broad to lessen the ambiguity of the term. In addition, a partnership or corporation that deputizes one of its members or directors to act as a director of another company will itself be held liable as a director under section 16(b).¹³⁹ The so-called "deputization theory" has caused considerable controversy.¹⁴⁰ First, because the concept of deputization is not yet well settled and the elements of deputization are dependent upon a case-by-case approach,¹⁴¹ it is difficult to predict when courts will invoke the theory. Second, because of the theory's ambiguity, there is a fear of unfettered expansion¹⁴² by a capricious court.¹⁴³ Third, in order to determine whether there has been a deputization, courts seem to have taken a subjective approach; sometimes they further inquire into whether there was actual use of inside information by the partnership/corporation or whether the member/director intended to act as a deputy.¹⁴⁴

(ii) *Officer*: The 1934 Act does not define the term "officer."¹⁴⁵ The SEC defines "officer" as "a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for an issuer, whether incorporated or unincorporated, functions corresponding to those performed by the foregoing officers."¹⁴⁶ The scope of the definition, however, has not been clearly established. Three different tests have been developed to define the term "officer": the literal test; the functional test; and the subjective test. Under the literal test, the scope of the term "officer" is determined primarily by the title of the insider, regardless of his real function and responsibility.¹⁴⁷ Under the functional test, on the other hand, "[t]he question is what this particular employee was called upon to do in this particular company, i.e., the relation between his authorized activities and those of this corpora-

138. 15 U.S.C. § 78c(a)(7) (1976).

139. See *Blau v. Lehman*, 368 U.S. 403, 410 (1962) (dictum); *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 262-66 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

140. The theory originated with Judge Learned Hand in *Rattner v. Lehman*, 193 F.2d 564, 567 (2d Cir. 1952) (concurring opinion).

141. *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 967 (S.D.N.Y. 1965).

142. See Deitz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 Fordham L. Rev. 1, 4 (1974).

143. Compare *Feder v. Martin Marietta Corp.*, 286 F. Supp. 937, 945-46 (S.D.N.Y. 1968), *rev'd*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) with *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 264-66 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

144. See, e.g., *Feder v. Martin Marietta Corp.*, 286 F. Supp. 937 (S.D.N.Y. 1968), *rev'd*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

145. Deitz, *supra* note 143, at 4 ("The definition of an officer for section 16(b) purposes . . . is far from settled.").

146. 17 C.F.R. § 240.3b-2 (1978).

147. *Lockheed Aircraft Corp. v. Campbell*, 110 F. Supp. 282, 285-86 (S.D. Cal. 1953); *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810, 813 (S.D. Cal. 1952).

tion."¹⁴⁸ Recently, the courts have shifted to a subjective test. The major element of this test is whether a specific insider had the opportunity to abuse inside information.¹⁴⁹ This test, as alluded to earlier, while being flexible, allows the courts to be arbitrary and impairs legal predictability.¹⁵⁰

(iii) *Timing of the Status as Director or Officer*: Congress unfortunately failed to indicate when a person, with respect to transactions he engages in, has to be an officer or director to be subject to section 16(b). Legal instability has resulted. Theoretically, as illustrated by Table 2, six cases are possible.

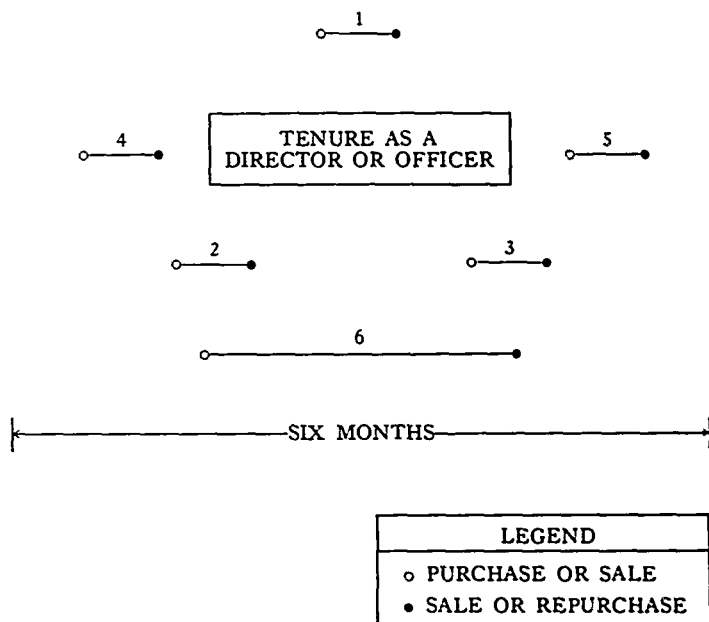


TABLE 2

In transaction 1, in which a person is a "director" or "officer" both at the time of the purchase and sale or at the time of the sale and

148. Colby v. Klune, 178 F.2d 872, 875 (2d Cir. 1949).

149. Schimmel v. Goldman, 57 F.R.D. 481, 486 (S.D.N.Y. 1973); Morales v. Holiday Inns, Inc., 366 F. Supp. 760, 763 (S.D.N.Y. 1973); Selas Corp. v. Voogd, 365 F. Supp. 1268, 1271 (E.D. Pa. 1973).

150. See Gold v. Sloan, 486 F.2d 340 (4th Cir. 1973), cert. denied, 419 U.S. 873 (1974). The Gold court concluded that since the defendant was ignorant of inside events—in this case, merger developments—there was no possibility of abuse. *Id.* at 351.

repurchase, he is subject to the section. No clear-cut judicial rules have been established for the other types of transactions.¹⁵¹ Some courts have inquired into the subjective aspect of transactions, that is, the possibility of abuse of inside information, in determining whether these other types of transactions are covered by the section.¹⁵² Such a pragmatic or subjective approach under the automatism of the section significantly impairs predictability because while courts seem willing to inquire into the subjective circumstances of a transaction to establish the possible abuse of inside information, they never permit insiders to prove their real intent or actual nonuse of such information. Thus, this approach is apt to lead to arbitrary results.¹⁵³ Furthermore, an inequitable imbalance arises between targets with which this approach is used and targets which are automatically subject to section 16(b). One can safely argue that to conduct a subjective inquiry in only one type of transaction (such as 2 or 3) and not in the other (such as 1) would be unfair.

(iv) *Beneficial Owner*: Congress failed to define the term "beneficial owner."¹⁵⁴ Thus, the same problems found in connection with the meanings of "officer" and "director" arise in this area as well. In 1935, the SEC described "beneficial ownership" as a position in which "by reason of any contract, understanding, relationship, agreement or other arrangement [a person] has benefits substantially equivalent to those of ownership."¹⁵⁵ This abstract definition, however, was of no assistance in predicting whether a person would be deemed a beneficial owner, and courts have resorted to the subjective approach to decide who falls within this definition.¹⁵⁶

Uncertainty in the notion of beneficial ownership plunges family members into an insecure situation. In 1966, the SEC issued a release which considerably expanded its 1935 definition of the term. The SEC ruled that absent special circumstances, "a person is regarded as the

151. *Allis-Chalmers Mfg. Co. v. Gulf & W. Indus., Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976) (type 2 is covered); *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970) (type 3 is covered); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959) (same); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965) (same). Courts have not yet discussed type 6. See *Wentz, Refining a Crude Rule: The Pragmatic Approach to Section 16(b) of the Securities Exchange Act of 1934*, 70 *Nw. L. Rev.* 221, 259 (1975).

152. *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 268 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959).

153. See, e.g., *Levy v. Seaton*, 358 F. Supp. 1 (S.D.N.Y. 1973). In *Levy*, a corporate officer who engaged in a type 5 transaction three months after severance from the corporation was held not liable. *Id.* at 5-6.

154. See *Senate Hearings*, *supra* note 19, at 6555-56.

155. SEC Securities Exchange Act Release No. 175 (Apr. 16, 1935).

156. See *Feldman & Teberg, Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 *W. Res. L. Rev.* 1054, 1065 (1966); *Wentz*, *supra* note 151, at 261.

beneficial owner of securities held in the name of his or her spouse and their minor children."¹⁵⁷ Undoubtedly, the basic philosophy behind the SEC's release is that the opportunity for abuse of inside information could generally pass from one family member to another through a family tie. The SEC has indicated that under its definition, "[t]he fact that ownership of securities and transactions in those securities are reported under Section 16(a) . . . does not necessarily mean that liability will result therefrom under Section 16(b)."¹⁵⁸ Nevertheless, courts seem receptive to using the SEC's definition to impose section 16(b) liability.¹⁵⁹ The danger of unfettered expansion of the scope of section 16(b) looms if the concept of a family tie is used to ensnare a person for whom the opportunity to abuse inside information is only a theoretical possibility.¹⁶⁰

F. *Two Regulatory Mechanisms for One Congressional Purpose:
An Incidental Cost*

Section 10(b) and rule 10b-5 currently effect the same congressional aim as section 16(b) does, albeit in a different way. Section 16(b) aims to deter speculative insider trading by compelling insiders to disgorge profits, whereas rule 10b-5 aims to achieve the same end by imposing compensatory liability on insiders. The coexistence of these two mechanisms, for the same congressional purpose, raises the problem of double liability.¹⁶¹

157. SEC Securities Exchange Act Release No. 7793 (Jan. 19, 1966), 31 Fed. Reg. 1005 (1966).

158. SEC Securities Exchange Act Release No. 7824 (Feb. 14, 1966), 31 Fed. Reg. 3175 (1966).

159. See, e.g., *Schur v. Salzman*, 365 F. Supp. 725, 732 (S.D.N.Y. 1973).

160. See, e.g., *Whiting v. Dow Chemical Co.*, 523 F.2d 680 (2d Cir. 1975). The holding of securities by a trust, partnership, or corporation has created problems similar to the one that exists when a family member holds securities. Regarding the holding of securities by a trust, see *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962, 966-67 (S.D.N.Y. 1965); 17 C.F.R. § 240.16a-8(a),(c),(e) (1978); *Wentz*, *supra* note 151, at 264-66. Regarding the holding of securities by a partnership, see SEC Securities Exchange Act Release No. 1965 (Dec. 21, 1938), 11 Fed. Reg. 10,970, 10,970-71 (1946); *Feldman & Teberg*, *supra* note 156, at 1078-79; *Wentz*, *supra* note 151, at 264 n.139. Regarding the holding of securities by a corporation, see SEC Securities Exchange Act Release No. 1965, 11 Fed. Reg. 10,970, 10,970-71 (1946). Compare *Blau v. Mission Corp.*, 212 F.2d 77, 80 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954) with *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965).

161. ALI Fed. Securities Code § 1413, Comment 21 (Tent. Draft. No. 2 1973); see *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 278 (S.D.N.Y. 1966), *aff'd in part and rev'd in part on other grounds*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); *Pappas v. Moss*, 257 F. Supp. 345 (D.N.J. 1966), *rev'd on other grounds*, 393 F.2d 865 (3d Cir. 1968). In *Diamond v. Oreamuno*, 29 A.D.2d 285, 290, 287 N.Y.S.2d 300, 305 (1968), *aff'd*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969), the court recognized that defendants-directors in a shareholder's derivative action might incur double liability if they were also sued by the purchasers of their stock for failure to disclose material information. See generally 6 L. Loss, *Securities Regulation* 3646-47 (2d ed. Supp. 1969); 3 L. Loss, *Securities Regulation* 1473-74 (2d ed. 1961).

Arguably, as one supporter of exposing insiders to double recovery states, "the causes of action created by the two sections are noticeably different in purpose and scope,"¹⁶² and "[insiders] simply run afoul of two distinct sections of the Exchange Act."¹⁶³ Furthermore, "if there is active fraud by the purchasing insider, a strong argument in favor of double recovery can be made on the basis that the single purchase involved wrongs against both the corporation and the selling shareholder."¹⁶⁴

These arguments, however, overlook the fact that Congress did not construct the double recovery system in the 1934 Act with the intent of wrestling with insider trading.¹⁶⁵ "Section 10(b) was not primarily designed to handle the insider trading problem, dealt with expressly by Section 16(b). Rather it was intended as a general prohibition of a relatively wide variety of deceitful or manipulative practices"¹⁶⁶ Moreover, the private recovery system under rule 10b-5 was not contemplated by the SEC when adopting the rule;¹⁶⁷ the system has been developed in the course of subsequent judicial construction and expansion of the rule.¹⁶⁸

Seeking to achieve a deterrent effect, Congress designed section 16(b) to compel forfeiture of speculative profits from insiders, and to that end, corporations were chosen as the operational instrument. As discussed earlier, the sole theoretical underpinning for corporations' cause of action—the agency-based corporate assets theory—has proven to be suspect.¹⁶⁹ Section 16(b) rests on a legal fiction that results in channeling compensation to issuing corporations even though they have not been victimized by insiders.

The double recovery system has no reasonable basis in public policy. Although there is some deterrent effect in divesting insider-agents of profits derived from exploiting information gained by virtue of their positions, the necessity of relieving victims of insider trading and reallocating resources to them should have priority over the necessity to compel the insider-agent to disgorge such profits and to account to the principal for them. Divestiture under section 16(b) usually worsens the financial condition of the wrongdoer and thereby impedes the

162. Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120, 1140 (1950) [hereinafter cited as *Prospects*].

163. *Id.* at 1141.

164. Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 Cornell L.Q. 53, 68 (1960) (footnote omitted).

165. See W. Painter, *Federal Regulation of Insider Trading* 19 (1968).

166. *Id.*

167. "§ 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

168. W. Painter, *supra* note 165, at 21-22.

169. See pt. I(B)(1) *supra*.

granting of relief to rule 10b-5 plaintiffs, particularly when, as usually is the case, the injured party does not have a cause of action against the issuing corporation which received the divested profits. Moreover, the disgorgement mechanism of section 16(b) is automatic and stronger than the compensation and recovery mechanism available to injured parties under rule 10b-5, and as a result puts such parties at a disadvantage.

The court in *Diamond v. Oreamuno*,¹⁷⁰ then, misconstrued the issue when it argued:

[T]he mere possibility of such a suit [asking for recovery of damages] is not a defense nor does it render the complaint insufficient. It is not unusual for an action to be brought to recover a fund which may be subject to a superior claim by a third party. If that be the situation, a defendant should not be permitted to retain the fund for his own use on the chance that such a party may eventually appear.¹⁷¹

The issue is not the propriety of an affirmative defense of double liability, but the inequity of a disgorgement mechanism which generally permits a noninjured corporate issuer to recover more easily than injured parties. In short, the problem is to whom the profits should be reallocated. If one operates under the assumption that profits should be reallocated to the injured parties, there is little justification for having a double recovery system which acts as an obstacle to reallocation.

How then can the risk of double liability be eliminated? Professor Stevens argues for giving precedence to the relief of injured parties:

The just result would seem to be to stay the corporate action, if one has been brought, to await the outcome of the suit by the shareholder in his individual right; if he recovers, that will diminish the purchaser's profit and should constitute a defense to the corporate cause of action.¹⁷²

Stevens' suggestion does not represent a complete solution to the problem of double liability, despite the validity of its underlying philosophy, because it is difficult for potential rule 10b-5 plaintiffs to find a pending section 16(b) action and because a section 16(b) action can be stayed pending a rule 10b-5 action only when both actions are *simultaneously* available. Furthermore, even if a defendant could stay the section 16(b) action, there is no guarantee under the existing case law that the recovery to the injured parties in the rule 10b-5 action is a legally cognizable defense to the section 16(b) action.¹⁷³

The second possible solution to the double liability problem is using the device of interpleader.¹⁷⁴ This solution is unfair because it compels

170. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

171. *Id.* at 504, 248 N.E.2d at 915, 301 N.Y.S.2d at 86.

172. R. Stevens, *Handbook of the Law of Private Corporations* § 150, at 702 (2d ed. 1949) (footnote omitted).

173. *Diamond v. Oreamuno*, 24 N.Y.2d at 504, 248 N.E.2d at 915, 301 N.Y.S.2d at 86.

174. ALI Fed. Securities Code § 1413, Comment 21 (Tent. Draft No. 2, 1973).

the injured parties to fight with the corporation in order to assert their rights. In other words, since the injured parties should recover in any event (even after the accounting to the corporation), interpleader is inappropriate. Insiders should not be in a position to say to the injured parties, " 'Fight it out; we'll pay the winner.' " ¹⁷⁵ In addition, there are technical difficulties in utilizing interpleader, that is, there is doubt under the present trend of court opinions whether the prerequisites for interpleader can be satisfied in this situation. ¹⁷⁶

The third possible method for avoiding double liability is to enact a provision against double liability such as the one found in section 1714(i) of the American Law Institute's Federal Securities Code. ¹⁷⁷ Section 1714(i) provides:

The profit [derived from short-term insider trading] is reduced by the amount of any damages, interest, and costs (not including the defendant's attorneys' fees) paid by the defendant to sellers or buyers in the transactions in question pursuant to (1) a judgment on a claim under [the antifraud provisions] or a comparable claim under State or foreign law or (2) settlement of such a claim if the defendant proves that the settlement was not collusive. If the defendant makes any such payment after he has paid the profit [derived from short-term insider trading] to the issuer, he may recover the amount of the payment in an action against the issuer, but in no event more than the net amount received by the issuer after payment by it (or out of the amount paid by the [insider/defendant]) of all costs . . . ¹⁷⁸

A close examination of section 1714(i) reveals that it will be inadequate. At least two problematic situations are conceivable. The first is the case in which, after the judgment in a rule 10b-5 litigation is rendered, a section 16(b) action is brought. The defendant can raise a defense that the payment to the injured parties destroyed his profit. Yet, such a defense is available only to the extent of "the amount of any damages, interest, and costs (not including the defendant's attorneys' fees) paid by the defendant to sellers or buyers." ¹⁷⁹ Because of the highest-in-lowest-out formula for the computation of profits under section 16(b), ¹⁸⁰ the usefulness of such a defense will be considerably circumscribed. In addition, even a slight excess of profits under section 16(b) will create the risk of double litigation. The financial burden of the defendant's attorney's fees represents nothing less than substantial double liability.

The second problematic case is that in which a rule 10b-5 litigation has been brought after the delivery of a judgment in a section 16(b)

175. R. Field & B. Kaplan, *Materials for a Basic Course in Civil Procedure* 148 (3d ed. 1973).

176. Because the courts tend to regard the causes of action created by §§ 10(b) and 16(b) as separate and distinct, *see Prospects, supra* note 162, at 1140-42, it is unlikely that the requirements for interpleader can be fulfilled. *See* Fed. R. Civ. P. 22.

177. ALI Fed. Securities Code § 1714(i). (Proposed Official Draft (1978)).

178. *Id.*

179. *Id.*

180. *See* notes 39-40 *supra* and accompanying text.

litigation. In this case, section 1714(i) is ineffectual in preventing double liability. It provides a way by which insiders can recover from the corporation only *after* being exposed to the burden of double litigation. Furthermore, it is theoretically possible that shareholders of the corporation can stop it from paying the insider the amount of the rule 10b-5 judgment against him by alleging that it constitutes waste of corporate assets, or that after payment they can raise a derivative action for waste of corporate assets. If these attacks by shareholders are successful, the risk of double liability will be substantial despite the scrupulous draftsmanship of the Federal Securities Code.

The basic unfairness of section 1714(i) is that it does not focus on providing relief to injured parties. The roundabout method of letting insiders recover from the corporation after their payment to the injured parties not only heightens the risk of double liability, but also impedes the smooth granting of relief to the injured parties. Section 1714(i) should have provided a way by which the injured parties could directly sue the corporation to the extent of the amount of the profit.

All of the previously described attempts at avoiding double liability, which were predicated on the existence of section 16(b), do not function well. The ultimate solution is the elimination of section 16(b). The consequence of enacting a provision like section 1714(i) would be to confine the function of section 16(b) to the scope of rule 10b-5—the amount of any damages paid by the insiders to the injured parties. Thus, one of the main *raison d'être* of section 16(b) would be lost.¹⁸¹ Furthermore, because of the automatism of section 16(b), the issuing corporation usually acquires the limited resources earlier than the injured parties. To allocate the resources, which ultimately belong to the injured parties, to the corporation first and thereafter to reallocate these resources to the injured parties represents nothing more than an unnecessary transfer of resources. In addition, the social resources themselves may be consumed and decline in value during transfer, for example, by the payment of attorney's fees. The methods for avoiding double liability on the precondition of the existence of section 16(b) are inconsistent with not only the judicial policy favoring relief to injured parties, but also with the social policy of conserving resources.

G. *To Repeal or Not To Repeal*

The critical questions this Article has examined are whether society needs section 16(b) and whether it is wise to maintain the mechanism in terms of its costs and benefits to society. The foregoing analysis has shown that insider trading has some benefits (*B*) for society. Since benefits from insider trading exist, the costs of social losses caused by

181. See pt. I *supra*.

diminishing the positive values of insider trading (C^2) also exist.¹⁸² The costs of enforcement (C^3) by attorneys as federal policemen are not only a huge¹⁸³ but also an unseemly expense for society. Section 16(b)'s ambiguities discourage early settlements and encourage subsequent appeals. Moreover, under section 16(b), society has to bear the enforcement costs even when defendants do not harm society. The cost of errors under section 16(b) is considerable because the section applies to every instance of insider trading that comes within the six-month limitation regardless of whether it is detrimental to the regulatory purpose.¹⁸⁴ Finally, the foregoing analysis has revealed that in addition to the aforementioned costs, section 16(b) involves several incidental costs (C^5). These are the costs of inequity, unpredictability, misallocating social resources (cost of impending relief to victims), and double liability.¹⁸⁵

The costs and benefits of section 16(b) are presented in Figure 5. Section 16(b) falls outside of the beneficial range of enforcement (P^2 - P^3). The costs of the section exceed its benefits. Professor Loss states that "§ 16(b) has a symbolic significance that must be, and

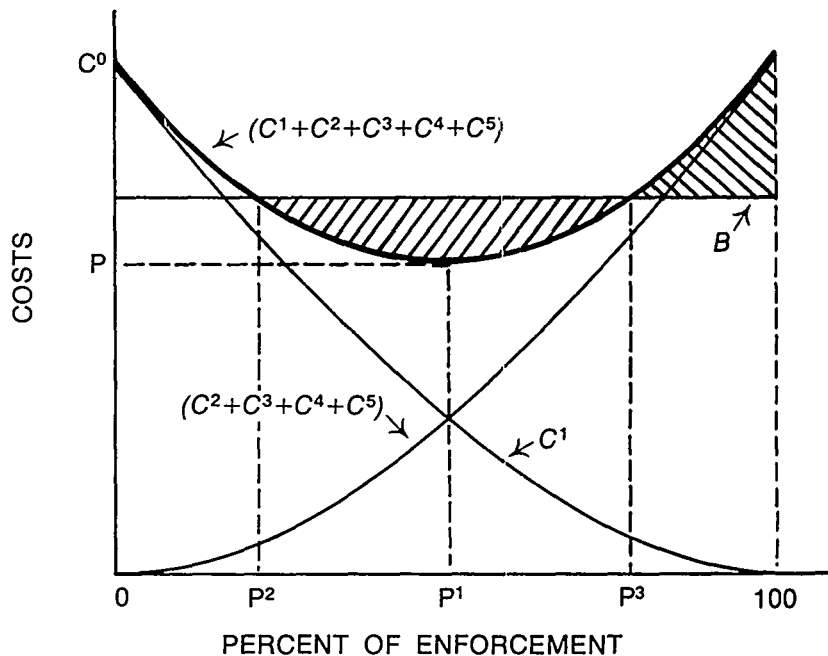


FIGURE 5

182. See pt. II(B) *supra*.

183. See pt. II(C) *supra*.

184. See pt. II(D) *supra*.

185. See pt. II(E), (F) *supra*.

deserves to be, recognized."¹⁸⁶ Presumably, by "a symbolic significance" he means that "it is just as important for the markets as for the courts not merely to do equity but to *appear* to do equity."¹⁸⁷ Such "a symbolic significance" does not deserve to be maintained at such exorbitant cost, especially in view of the fact that the federal securities regulation scheme now has, in addition to section 16(a)'s filing requirements¹⁸⁸ and section 16(c)'s prohibition against short sales,¹⁸⁹ rule 10b-5's antifraud provisions.

Rule 10b-5, unlike section 16(b), is not an automatic, 100% enforcement mechanism. The rule prohibits only the actual abuse of insider information. Furthermore, it is a compensation mechanism used primarily by private plaintiffs who are victims of insider trading. Because of these characteristics, rule 10b-5 can be enforced less expensively and more equitably than section 16(b).

III. INSIDER TRADING REGULATION IN JAPAN

Recently in Japan, there have been movements for reinforcement of the present regulatory scheme which includes an analogue to section 16(b). The necessity for reinforcement is clear. However, the manner in which the present regulatory scheme should be reinforced requires careful and critical consideration. The earlier discussion of the American experience under section 16(b) is fecund with suggestions as to the applicability of section 16(b)-type regulation to Japan.

A. *Present Regulatory System*

1. The Statutory Scheme

The present statutory scheme for the regulation of insider trading in Japan consists of the provision for the disgorgement of short-swing

186. ALI Fed. Securities Code § 1413, Comment 2 (Tent. Draft No. 2, 1973)

187. 5 L. Loss, *Securities Regulation* 2999 (2d ed. Supp. 1969).

188. Section 16(a) provides: "Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 78f of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 78f(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month." 15 U.S.C. § 78p(a) (1976).

189. Section 16(c) is quoted at note 77 *supra*.

profit (article 189 of the SEL),¹⁹⁰ the antifraud provision (article 58 of the SEL),¹⁹¹ and the prohibition of insider trading by the officers or employees of a securities corporation (article 50 of the SEL¹⁹² and the Ministerial Order in accordance with it¹⁹³). Article 189 of the SEL provides in pertinent part:

For the purpose of preventing the unfair use of secret information of a corporation which may have been obtained by any officer or major shareholder (the term refers to the shareholder or the contributor who holds or owns more than ten percent of the corporation's total number of issued shares or the total amount of contributions in his own name or in the name of other persons including fictitious person; the same shall apply hereinafter) of the corporation by reason of his office or position in the corporation, if such person realizes any profit by doing purchase within six months after sale, or sale within six months after purchase, of shares of the corporation, the corporation may claim him to tender such profit to the corporation.

2. If the corporation fails to claim, in accordance with the provisions of the preceding paragraph, within sixty days after any shareholder of the corporation made a request that the corporation shall claim in accordance with the provisions of the preceding Paragraph, such shareholder may claim in the name of and on behalf of the corporation.¹⁹⁴

The SEL provides criminal and administrative sanctions against the violations of the foregoing provisions. An intentional violator of article 58 will receive a criminal sanction.¹⁹⁵ When such violator is a securi-

190. Article 189 is quoted at text accompanying note 194 *infra*.

191. Article 58 of the SEL states in pertinent part: "No person shall commit an act described in the following Items: (1) To employ any fraudulent device, scheme or artifice with respect to buying, selling or other transactions of securities. (2) To obtain money or other property by using documents or by any representation which contain an untrue statement of a material fact or any omission to state a material fact necessary to make the statements therein not misleading." Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948, art. 58(1), (2) (1971). This and all subsequent citations to the Japanese Securities Exchange Law are made to an English translation: Japan Securities Research Institute, Securities and Exchange Law (1975).

192. Article 50 of the SEL states in pertinent part: "It shall be unlawful for any securities corporation, its officers or employees to commit such act as described in the following Items: . . . (3) Such acts relating to buying, selling or other transactions of securities, other than those referred to in the preceding two paragraphs, as may be prescribed by the Ministerial Order as prejudicial to the protection of investors, detrimental to the fairness of transactions or undermining the credibility of the securities industry." Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948, art. 50(3) (1971).

193. The Ministerial Order provides that transactions by officers or employees of securities corporations based upon inside information received while in their capacity as officers or employees shall constitute unlawful conduct under article 50 of the SEL. Shokengaisha no Kenzensei no Junsokuto ni kansuru Shorei, Ministry of Finance Order No. 60, § 1(5) (Nov. 5, 1965).

194. Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948, art. 189(1), (2) (1971). The article further provides: "3. The right to claim to the officer or major shareholder under the provisions of the preceding two Paragraphs shall be cancelled unless the claimant exercised it within two years from the date on which such profit was realized.

"4. The provisions of the preceding three Paragraphs shall not be applied to the case where such major shareholder was not such either at the time of purchase or sale." *Id.* art. 189(3), (4).

195. SEL art. 197 provides in pertinent part: "Any person who comes under any of the

ties corporation or "a registered representative"¹⁹⁶ of a securities corporation, he will be subject to administrative sanction, such as cancellation of license or suspension of business.¹⁹⁷ The same kind of administrative sanction is applied to violators of article 50 of the SEL.¹⁹⁸

2. Lack of Enforcement of the Statutory Scheme

The statutory provisions against insider trading have rarely been enforced in Japan. Since its enactment, article 189 has been invoked only once.¹⁹⁹ In 1963, Shokusanjutasogō Kabushikikaisha Corporation brought an action under the article against its former chief executive officer to recover the short-swing profit he had made.²⁰⁰ In addition, no civil, criminal, or administrative action in which article 58 was applied to insider trading has been reported.²⁰¹ Furthermore, there has been no case in which the Ministry of Finance has asked a court to issue an injunction against insider trading as provided for in article 187 of the SEL.²⁰² The lack of enforcement of the statutory scheme, however, should not be equated with the absence of insider trading in Japan. Several cases of suspected insider trading have been reported.²⁰³ Moreover, in Japan directors and officers usually acquire

following Items shall be confined to imprisonment for not more than three years or be fined not more than three hundred thousand yen: . . . (2) Any person who has violated the provisions of Article 58" *Id.* art. 197(2).

196. A "registered representative" includes officers or employees of a securities corporation engaging in buying and selling of securities, acting as brokers, or the like. *See id.* art. 62.

197. *See id.* arts. 35, 64-3.

198. *Id.*

199. A. Takeuchi & S. Michida, *supra* note 5, at 532 n.5; Horiguchi, *Torishimariyaku no Futo Rieki no Teikyo* (1), 656 Shojihomu 1 (1974); *Ripporonteki Kosatsu*, *supra* note 8, at 700; *see* Shoken Torihikiho Kenkyukai, *Beikoku Renposhokenhotenan no Kenkyu* (2), Inbesutomento, June 1975, at 39, 42 [hereinafter cited as *Beikoku* (2)]; Shoken Torihikiho Kenkyukai, *Beikoku Renposhokenhotenan no Kenkyu* (1), Inbesutomento, April 1975, at 23, 41.

200. Horiguchi, *supra* note 199.

201. *See* Kanzaki, *supra* note 8, at 761; Takeuchi, *supra* note 8, at 139, *Ripporonteki Kosatsu*, *supra* note 8, at 700.

202. Takeuchi, *supra* note 8, at 140. Article 187 of the SEL provides in pertinent part: "Court may, if it deems it urgent and essential, and necessary and appropriate for the public interest and for the protection of investors, upon plea from the Minister of Finance, order any person, who engages or is about to engage in any act which constitutes a violation of this Law or Order issued under this Law, to cease or suspend such action." Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948, art. 187 (1971).

203. *See, e.g.*, Nippon Netsugaku, 780 Shojihomu 30 (Osaka Dist. Ct. 1977). The court, however, did not deal with the issue of insider trading. The case is discussed in: Kanzaki, *Nippon Netsugaku Jiken no Hotekikento*, 676 Shojihomu 2 (1974); Nippon Keizai Shinbun, May 23, 1974, at 15. For an international reaction to the case, *see* Wall St. J., June 19, 1974, at 1, col. 6. For a discussion of other cases, *see*: Horiguchi, *supra* note 199; Nippon Keizai Shinbun, Feb. 2, 1979, at 13; *id.*, Feb. 23, 1978, at 13; *id.*, Feb. 21, 1978, at 15; Asahi Shinbun, Sept. 4, 1973, at 18.

stock in their corporations when they assume their posts.²⁰⁴ Furthermore, some commentators maintain that corporations in Japan tend to report insider information to banks or other financial institutions earlier than they make it public.²⁰⁵

It is extremely important, for purposes of achieving future reinforcement of the regulatory scheme, to analyze the reasons for the current lack of enforcement. The main reason for the inactivity of article 189 is said to be the deletion of the filing requirement for directors, officers, and principal stockholders. Deleted article 188, which was equivalent to section 16(a) of the 1934 Act, provided that directors, officers, and principal stockholders file a statement with the Japanese Securities and Exchange Commission (Commission) indicating the amount and kind of all securities owned. It further directed that if there had been a change in the amount of securities owned, then a statement indicating such change should be filed with the Commission within ten days after the close of each calendar month.²⁰⁶ Article 188 was deleted in 1953 by the Law for the Partial Amendments of the Securities Exchange Law (Law for the Partial Amendments).²⁰⁷ Most scholars believe the article was deleted because it had not been effective; the Commission had not regularly released filings of insiders or made them public.²⁰⁸ This explanation originally appeared in a comment by the government officials who presumably drafted the Law for the Partial Amendments.²⁰⁹

Perhaps the real reason for the deletion of article 188 was not its inefficiency but that it was regarded as excessive. The Law for the Partial Amendments is described as "the correction of excessiveness of the laws enacted under the Occupation."²¹⁰ Indeed, immediately after the termination of the Occupation in April, 1952, the Commission, which had been an independent agency, was abolished and replaced

204. Shoken Torihikiho Kenkyukai, *Renposhokenhotenan no Kenkyu* (3), Inbesutomento, August 1975, at 27, 38 (remarks of Mr. Kobayashi).

205. Yazawa & Yasui, *Shokenseisaku no Kongonokadai*, 748 *Shojihomu* 4, 10 (1976).

206. H. Oda, C. Miwa & M. Sumi, *Kaisei Shokentorihikiho*, *Shoken Toshishintakuho Kaisetsu* 179 (1954) [hereinafter cited as H. Oda].

207. *Shokentorihikiho no Ichibu o Kaiseisuru Horitsu* (Law for the Partial Amendments of the Securities Exchange Law), Law No. 142 of 1953; see H. Oda, *supra* note 206, at 5.

208. See, e.g., Takeuchi, *supra* note 8, at 138; Tatsuta, *Ininjo Kisei Kabushiki Kokai Kaitsuke: Naibusha Torihiki*, in 2 *Amerika To Nippon no Shokentorihiki Ho* 564 (L. Loss & M. Yazawa ed. 1975) [hereinafter cited as *Naibusha*]. Some scholars say that since article 188 did not adopt the beneficial ownership test, insiders had been able to evade the obligation by using another person's name or a fictitious name. Takeuchi, *supra* note 8, at 138; *Naibusha*, *supra*, at 564.

209. The comment said: "The reason for this filing requirement was perhaps to be able to know of selling and buying of stocks in listed corporations by directors or officers of such corporations and to prevent unfair conduct such as manipulation. Since the article had been inefficient, it was deleted." H. Oda, *supra* note 206, at 180 (original in Japanese).

210. *Id.* at 5.

by only one section of a bureau of the Ministry of Finance.²¹¹ (Presently the section has been raised to the Securities Bureau.) The opposition of the business community to article 188 triggered its demise.²¹² This opposition is noteworthy because it suggests that far from being inefficient, the article had some deterrent effect. Apparently, the reporting requirement, backed by criminal sanction, functioned as psychological pressure upon insiders to refrain from advantageously exploiting inside information on the markets. In this connection, it should be recalled that in the United States, the industry proposals had concluded that the disclosure provisions of section 16(a) and the prohibition of short-sales contained in section 16(c) were effective deterrents to the unfair use of inside information and that further deterrents, such as section 16(b), were unnecessary.²¹³ In spite of the deletion of article 188, the SEL still has article 190 which is equivalent to section 16(c) of the 1934 Act.²¹⁴

The fundamental reason for the lack of enforcement under article 189 is, simply stated, the foreign nature of the article and the difficulties of its application to Japan's unique circumstances. At the core of regulations such as section 16(b) and article 189 are the substantial delegation of the regulatory power of a nation to private citizens and the deterrent effect of the disgorgement mechanism. Both are quite foreign to the Japanese legal structure.

As Professor Ueyanagi points out, the traditional and common means to attain an administrative purpose in Japan has been through the imposition of administrative and criminal sanctions.²¹⁵ A clear distinction exists between criminal and civil matters.²¹⁶ Even civil actions for damages, which are motivated by private interests, have rarely been deemed a means to attain administrative goals.²¹⁷ For instance, the Japanese Antimonopoly Law²¹⁸ does not contain a provision for treble damages,²¹⁹ and its provision for strict liability for

211. T. Suzuki & I. Kawamoto, *supra* note 5, at 24-25.

212. Mitsuki, *Kabushiki Shijo Torihiki niokeru Insaida to Autosaida*, Inbesutomento, Sept.-Oct. 1965, at 14, 16; see K. Kanzaki, *Shokentorihikikisei no Kenkyu* 149 n.83 (1968).

213. See note 77 *supra* and accompanying text.

214. Article 190 of the SEL provides: "No officer nor major shareholder of a corporation, the shares of which are listed for trading on a securities exchange, shall sell such portion of the same shares as he does not have actually." *Shokentorihiki Ho* (Securities Exchange Law), Law No. 25 of 1948, art. 190 (1971).

215. *Beikoku* (2), *supra* note 199.

216. See Tanaka & Takeuchi, *Ho no Jitsugen niokeru Shijin no Yakuwari* (1), 88 *Hogakukyokaizasshi* 521, 527 (1971) [hereinafter cited as *Ho no Jitsugen* (1)].

217. See generally Tanaka & Takeuchi, *Ho no Jitsugen niokeru Shijin no Yakuwari* (4), 89 *Hogakukyokaizasshi* 1033, 1033-82 (1972).

218. *Shitekidokusen no Kinshi oyobi Koseitorihiki no Kakuho nikansuru Horitsu* (Antimonopoly Law), Law No. 54 of 1947.

219. See *Ho no Jitsugen* (1), *supra* note 216, at 524.

damages²²⁰ has been used only a few times,²²¹ notwithstanding the fact that, in most instances, victims have some private incentive to bring such action. Thus, it is safe to say that the disgorgement mechanism, which is not backed by private incentive, is alien to the Japanese legal system, and its infrequent operation should hardly be surprising. In addition, because of the disgorgement mechanism's automatism, it is a form of strict liability. To use strict liability to achieve the administrative purpose of disgorgement is quite unusual in Japan, although several examples of strict liability for private compensation do exist.²²²

The lack of private enforcement in Japan is a symptom of the monopoly on enforcement by administrative and public agencies. One manifestation of this monopoly is that administrative agencies have refrained from assisting plaintiffs in private litigation.²²³ Japan does not have a system of *amicus curiae* by which an administrative agency can submit a brief in a private litigation.²²⁴ Moreover, no case in which a preceding action by an administrative agency substantially assisted subsequent private litigation has been reported²²⁵ and no system of adopting the result of litigation by an administrative agency as *prima facie* evidence in a private litigation has been developed.

One of the major factors accelerating the administrative agencies' monopoly on enforcement is the relative dearth of attorneys in Japan. The ratio of attorneys to laymen is only one-fourteenth of that in the United States.²²⁶ The present number of practicing attorneys in Japan is approximately eleven thousand and only about three or four hundred attorneys are admitted each year. Because attorneys are in short supply, they have had no need to expand their businesses.²²⁷ As a result, attorneys have no incentive to initiate a system of private policemen. In summary, because the efficient operation of section 16(b)-type regulation depends heavily upon the philosophy of private enforcement and the private motives of attorneys, it is a quite natural and inevitable consequence that article 189 has not functioned, in Japan.²²⁸

220. *Shitekidokusen no Kinshi oyobi Koseitorihiki no Kakuho nikansuru Horitsu* (Antimonopoly Law), Law No. 54 of 1947, art. 25.

221. *Ho no Jitsugen* (1), *supra* note 216, at 524-25.

222. See I. Kato, *Fuhokoi* 5-30 (2d ed. 1974).

223. Tanaka & Takeuchi, *Ho no Jitsugen niokeru Shijin no Yakuwari* (3), 89 *Hogakukyokaizasshi* 879, 912-15 (1972).

224. *Id.* at 912-13.

225. In contrast, the United States Supreme Court has recently held that a defendant in a private damage action is collaterally estopped from relitigating issues of fact previously determined in an injunctive suit brought by the SEC. *Parklane Hosiery Co. v. Shore*, 99 S. Ct. 645 (1979).

226. *Ho no Jitsugen* (1), *supra* note 216, at 536.

227. *Id.* at 539.

228. K. Fujita, *supra* note 6, at 305-07; Fujita, *supra* note 5, at 11.

3. Administrative Guidance and Self-Regulation

Because of the inactivity of enforcement under the statutory scheme, actual regulation of insider trading in Japan has been effected, to a considerable extent, by administrative guidance and self-regulation. The circular notice issued in 1971 by the Director of Securities Bureau of Ministry of Finance to the directors of Regional Finance Bureaus and the Federation of Japan Securities Business Associations (1971 notice) states, in pertinent part:

Each securities corporation, when accepting orders involving the buying or selling of stocks in a corporation from directors, officers, or principal shareholders of such a corporation, . . . shall if necessary confirm backgrounds and reasons for such orders, and when it seems that such transactions violate laws and regulations, shall warn such persons, refuse such orders, and report the fact of such refusal to each stock exchange.²²⁹

Furthermore, one month before the circular notice, a newspaper reported that the Tokyo Stock Exchange (Exchange) had started self-regulation against insider trading.²³⁰ The gist of self-regulation is: (1) the Ministry of Finance and the Exchange will, on behalf of shareholders, urge violators to disgorge short-swing profit; (2) corporations will submit reports confirming performance of such disgorgement; (3) the Exchange will, when it finds that securities corporations intentionally participated in such insider trading, impose a fine or suspend their trading. Approximately two years after the government's 1971 notice, the Exchange issued its own notice to representatives of listed corporations; this notice warned that transactions by officers or directors of stocks in their own corporations may violate articles 58 and 189 of the SEL.²³¹ A later Exchange notice emphasized the importance of the first Exchange notice.²³² In one case the Exchange successfully compelled a violator to disgorge short-swing profits by relying on the self-regulatory power.²³³

B. Movement for Reinforcement

Persistent pressure has been exerted by academicians for new legislation governing insider trading regulation.²³⁴ The Ministry of Finance

229. Okurasho Shokenkyoku, Jikoboshito nitsuite, Zoshohi No. 452 (Feb. 24, 1971), quoted in Kanzaki, *supra* note 8, at 760 (original in Japanese).

230. Nippon Keizai Shinbun, Jan. 13, 1971, at 5; see *News: Tosho Kaishayakuinto niyoru Jishakabubaibai no Kisei ni Noridasu*, 547 Shojihomu 27 (1971).

231. Tokyo Shoken Torihikisho, Jojokaisha no Kankeisha niyoru Jishakabu no Baibaitorihiki nitsuite, Toshajokan No. 1621 (Nov. 17, 1972); see Kanzaki, *supra* note 8, at 760.

232. Tokyo Shoken Torihikisho, Zaimunaiyo no Tekiseikaiji oyobi Jishakabubaibai nitsuite, Toshajokan No. 120 (Feb. 16, 1973).

233. Takeuchi, *supra* note 8, at 145.

234. See note 8 *supra* and accompanying text.

(to be exact, the Securities Counselling Commission²³⁵), however, has not espoused the enthusiasm expressed in academic circles. Instead, the Ministry has assumed a more cautious attitude. The Ministry of Finance reasons that reinforcement of administrative and self-regulatory mechanisms is appropriate and amendment of the present statute or new legislation is not necessary.²³⁶

The negative attitude of the Ministry of Finance has been strongly criticized by those within the academic community.²³⁷ In this connection, the attitude of the Ministry of Justice, as reflected in a recent questionnaire, is noteworthy. The Ministry of Justice, which has jurisdiction over amendment of the corporation law,²³⁸ sent a questionnaire to various individuals to canvass their respective opinions concerning possible amendment of the corporation law.²³⁹ The Ministry of Justice asked whether it is appropriate to enact provisions in the corporation law for preventing directors and the like from abusing inside information. Affirmative responses have been in the majority.²⁴⁰ Enactment of such a provision would mean not only the transfer of articles 58 and 189 of the SEL to the corporation law, but also reinforcement of insider trading regulation. Although the Ministry of Justice is not in a position to exercise jurisdiction over the SEL, the questionnaire obviously gives strong impetus to the movement for reinforcement.

C. *Proposal for Japan*

The following is a proposal for Japan on the basis of the foregoing analysis. Article 189 (the Japanese counterpart to section 16(b)) should be deleted, provided that the already deleted article 188 (the Japanese counterpart to section 16(a)) is revived and reinforced, and that article 58 (the Japanese counterpart to section 10(b)) is fundamentally rein-

235. The Securities Counselling Commission is an advisory organ to the Ministry of Finance which was established upon the abolition of the Securities and Exchange Commission. T. Suzuki & I. Kawamoto, *supra* note 5, at 24-25. SEL art. 165 provides: "A Securities Counselling Commission . . . shall be established as an auxiliary body to the Ministry of Finance for the purpose of investigating and deliberating important matters relating to the issuing, buying, selling and other transactions of securities." Shokentorihiki Ho (Securities Exchange Law), Law No. 25 of 1948, art. 165 (1971).

236. Shokentorihiki Shingikai, Kabunushikosei no Henka to Shihonshijo no Arikata nitsulte 33 (May 11, 1976).

237. See, e.g., *Ripporonteki Kosatsu*, *supra* note 8, at 701.

238. Sho Ho (Commercial Code), Law No. 48 of 1899.

239. Homusho Minjikyoku Sanjikanshitsu, *Kaishaho Kaisei nikansuru Mondaiten* (June 12, 1975), reprinted in 728 Shojihomu 33 (1975) and 704 Shojihomu 6 (1975); see Kawamoto, Takenaka, Yazawa & Shimizu, *Torishimariyaku, Torishimariyakukaiseido no Kaizensaku*, 707 Shojihomu 2, 22 (1975) (remarks of Professor Yazawa).

240. Inada, *Kaishaho Kaisei ni kansuru Kakukai Iken no Bunseki*, 728 Shojihomu 4, 18 (1976).

forced. The disadvantages of section 16(b)/article 189-type regulation have been discussed above and will not be reiterated. Simply stated, it is both undesirable and expensive for a society to have such a regulatory mechanism. One may argue that the mere existence of the article will do no harm to Japanese society, since it is unlikely that the article will actually be used. Lack of enforcement of a statute cannot justify its preservation, but it does support its elimination.

Reinforcement of article 188 is a two-fold process. First, the Ministry of Finance should establish a public release system whereby insider filings are regularly released to the public. Second, the scope of article 188 should be expanded. Under the deleted version, only directors, officers, and principal shareholders of corporations whose securities are listed on any stock exchange were subject to the reporting requirement.²⁴¹ The opposition of business to article 188 suggests that its revival will have a substantial deterrent effect on insider trading.²⁴² A provision for criminal sanctions against violations of article 188 should also be revived. Perhaps, most importantly, the Ministry of Finance should strictly enforce the article. The Ministry should take the appropriate budgetary measures and augment its staff if necessary to achieve effective enforcement.

Article 58 should also be reinforced. It should be made clear that article 58 applies to insider trading and that violators will be subject to civil liability.²⁴³ Information released under article 188 will provide substantial assistance for potential plaintiffs who invoke article 58. The American experience will provide useful suggestions for a Japanese attempt at reinforcement. However, Professor Tatsuta's proposal,²⁴⁴ which relies on the Federal Securities Code of the American Law Institute, is perhaps too detailed and circumstantial to be presently introduced into Japan, where there has been no judicial development in the area of insider trading liability. To make it unlawful for insiders to trade on the basis of inside information and to impose civil liability for rescission or damages as well as criminal penalties upon insiders would be appropriate and sufficient for present Japan. A statute patterned after the Corporate Securities Law of California²⁴⁵ would be compatible with Japanese society. A more detailed scheme of regulation should await further judicial development.

Finally, administrative supervision and guidance and self-regulation should be further reinforced, regardless of whether the foregoing

241. See H. Oda, *supra* note 206, at 179. In contrast, section 16(a) covers non-listed securities. 15 U.S.C. 78p(a) (1976).

242. See notes 212-13 *supra* and accompanying text.

243. Yazawa, *supra* note 5, at 37; see Kanzaki, *supra* note 8, at 801-02; Takeuchi, *supra* note 8, at 146.

244. Tatsuta Proposal, *supra* note 8.

245. Cal. Corp. Code §§ 25000-25804 (West 1977 & Supp. 1978); see notes 28-29 *supra*.

reinforcement is achieved. In Japan's unique circumstances, even if article 58 is reinforced, it would not develop as dynamically as rule 10b-5 has and would not be used as frequently as rule 10b-5.²⁴⁶ To offset this Japanese peculiarity, administrative regulation and self-regulation must play an important role.²⁴⁷

246. Professor Loss claims that article 58 of the SEL along with the provision of general tort liability in article 709 of the Civil Code would develop in the same way as rule 10b-5. Loss, *Amerika niokeru Kigyonaibushatorihiki toknini Shinningimu no Gainen o megutte*, 10-9 Shoken-keizai Jiho 1, 14 (1970). Article 709 of the Civil Code states: "A person who violates intentionally or negligently the right of another is bound to make compensation for damage arising therefrom." Mimpo (Civil Code), Law No. 89 of 1896, art. 709 (translation in Ministry of Justice, Civil Code of Japan (1962)). This suggestion, however, is considered optimistic. Judicial development of article 58 of the SEL is unlikely because Japan, unlike the United States, does not operate under the common law system.

247. Administrative regulation, including administrative guidance and self-regulation have functioned as substitutes for private enforcement in Japan. See pt. III(A)(2), (3) *supra*. Perhaps these are the most efficient and least costly regulatory schemes that Japanese society can have.